CHINA'S INDUSTRIAL REFORM

AND FOREIGN ECONOMIC DEVELOPMENT

--- A Case Study from the Xiamen Special Economic Zone

by

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"The Special Economic Zones are a window, being the window of technology, the window of management, the window of knowledge, and the window of foreign policy."

Deng Xiaoping

ABSTRACT

This thesis seeks to advance the study on China's Special Economic Zones (SEZs) by exploring two important issues untouched by previous researches --- the reasons for the problem of policy inconsistency, ambiguity and unpredictability in the SEZs, and the effectiveness and significance of their experimental function as a "laboratory" for China's ongoing industrial reform and "open-door" policy. The Xiamen SEZ, rarely investigated by Western scholars, is chosen as the object of this case study because of its unique suitability. It is hoped that the findings from this thesis will significantly enhance the understanding of the difficulty and complexity of the reform and openness in China in general and in the SEZs in particular.

This thesis approaches the two issues from three perspectives, which reflect three most important relationships regarding the development of the SEZs --- the one between the economic reform and the Special Policy, the one between the local economic development and foreign direct investment (FDI), and the one between the SEZs and the domestic economy. It examines the enterprise reform, transformation of the local industry through utilizing FDI, and the relationship between the foreign trade reform and the price reform, in the Xiamen SEZ in its first decade of the 1980s. In particular, it includes a detailed analysis of the characteristics and effects of Taiwan investment in Xiamen in recent years and hence represents one of very few, if not the first, serious studies, at the moment, on the subject.

It concludes that the policy problem in Xiamen has been caused mainly by 1) the confusion of the economic reform and the implementation of the Special Policy, 2) the increasing dominance of Taiwan capital on the local economy, and 3) the close institutional link between the SEZ and the domestic economy. Also, it finds that a decade of the reform and development in Xiamen has produced few innovative and applicable experiences which could benefit the domestic reform and "open-door." Thus, the effectiveness and significance of the SEZ's experimental function has so far been very limited.

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I, of course, am solely responsible for the contents of this thesis.

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List of Abbreviations

The following abbreviations are used in the text and bibliography. Titles of periodicals are given in *italics* and, in the case of Chinese language ones, their English translation (in parentheses).

ACE --- Almanac of China's Economy.
ACFERT --- Almanac of China's Foreign Economic Relations and Trade.
AFE --- Almanac of Fujian's Economy.
AS --- Asian Survey.
AXSEZ --- Almanac of the Xiamen Special Economic Zone.
BR --- Beijing Review.
CBR --- *The Chinese Business Review.*
CBTR --- China-Britain Trade Review.
CCP --- The Chinese Communist Party.
CME --- Contractual Management Enterprise.
CMJJ --- Caimao Jingji (Finance and Trade Economics).
CN --- China Newsletter.
COE --- Collective-Owned Enterprise.
CQ --- China Quarterly.
CRS --- The Contract Responsibility System.
DE --- Developing Economies.
DWMYYJ --- Duiwai Maoyi Yanjiu (Studies on Foreign Trade).
EJ --- Economic Journal.
EPZ --- Export Processing Zone.
ESCAP --- The Economic and Social Commission for Asia and the Pacific, United Nations.
FCJ --- Free China Journal.
FCR --- Free China Review.
FDI --- Foreign Direct Investment.
FEAC --- Foreign Exchange Adjustment Centre.
FEER --- The Far Eastern Economic Review.
FIE --- Foreign-Invested/Involved Enterprise.
FJDWMY --- Fujian Duiwai Maoyi (Fujian Foreign Trade).
FJJJ --- Fujian Jingji (Fujian Economy).
FSB --- Fujian Statistical Bureau.
FTB --- Foreign Trade Bureau.
FTC --- Foreign Trade Corporation.
FTP --- Free Trade Port.

FTZ --- Free Trade Zone.
FYP --- Five-Year Plan.
FZSB --- Fuzhou Statistical Bureau.
FZYJ --- Fangzhang Yanjiu (Development Studies).
FZZLYJ --- Fangzhang Zhanlue Yanjiu (Studies on Development Strategy).
GAJJ --- Gang-ao Jingji (Hong Kong and Macau Economies).
GJJJMY --- Guoji Jingji he Maoyi (International Economy and Trade).
GJMY --- Guoji Maoyi (Intertrade).
GJMYWT --- Guoji Maoyi Wenti (Issues on International Trade).
GMJJJHYGL --- Guomin Jingji Jihua yu Guanli (National Economic Planning and Management).
GVIAO --- Gross Value of Industrial and Agricultural Outputs.
GVIO --- Gross Value of Industrial Outputs.
GYJJ --- Gongye Jingji (Industrial Economics).
HEA --- Horizontal Economic Association.
HQ --- Hongqi (Red Flag).
IMF --- International Monetary Funds.
JB --- Jing Bao (The Mirror).
JEC --- The Joint Economic Committee of the U.S. Congress.
JEL --- Journal of Economic Literature.
JEV --- Joint Equity Venture.
JJDB --- Jingji Daobao (Economic Reporter).
JJGZZYJZL --- Jingji Gongzhuoze Yanjiu Zhiliao (Research Materials for Economists).
JJRB --- Jingji Ribao (Economic Daily).
JJTQZL --- Jingji Tequ Zhiliao (SEZ Digest).
JJTZGG --- Jingji Tizhi Gaige (Economic Structural Reform).
JJTZGGBG --- Jingji Tizhi Gaige Baogao (Reports on the Economic Structural Reform).
JJWTTT --- Jingji Wenti Tantao (Exploration on Economic Problems and Issues).
JJYJ --- Jingji Yanjiu (Economic Studies).
JWTL --- Journal of World Trade Law.
LLDT --- Lilun Dongtai (Development of Theory).
MOFERT --- The Ministry of Foreign Economic Relations and Trade (after 1984).
MOFT --- The Ministry of Foreign Trade (before 1984).
NICs --- Newly Industrialized Countries.
OECD ---Organisation for Economic Corporation and Development.
PC --- Problems of Communism.
PRC --- The People's Republic of China.
QJE --- The Quarterly Journal of Economics.
RMB --- Renminbi (China's domestic currency).
RMRB --- Renmin Ribao (People's Daily).
RMRBh --- Renmin Ribao, haiweibang (People's Daily, overseas edition).
SCRG --- The State Council Research Group.
SEZ --- Special Economic Zone.
SJJJDB --- Shijie Jingji Daobao (World Economic Herald).
SOE --- State-Owned Enterprise.
SPC --- The State Planning Commission.
SSB --- The State Statistical Bureau.
STP --- Separation of Tax and Profits.
TDI --- Taiwan Direct Investment.

TFE --- Total Factor Productivity.
TGXX --- *Tigai Xinxi* (Reform Information).
TQJJ --- *Tequ Jingji* (SEZ Economy).
TQKFCSJJ --- *Tequ yu Kaifang Chengshi Jingji* (Economies of the SEZs and Open Cities).
TQXX --- *Tequ Xinxi* (SEZ Information).
TVE --- Township and Village Enterprise.
UNCTAD --- United Nations Conference on Trade and Development.
UNCTC --- United Nations Centre for Transnational Corporations.
UNIDO --- United Nations Industrial Development Organisation.
WBRO --- *World Bank Research Observer.*
WFOE --- Wholly Foreign-Owned Enterprise.
XMDXXB --- *Xiamen Daxue Xuebao zheshebang* (Bulletin of Xiamen University, edition of philosophy and social sciences).
XMRB --- *Xiamen Ribao* (Xiamen Daily).
XMTJ --- *Xiamen Tongji* (Xiamen Statistics).
XMTQYJ --- *Xiamen Tequ Yanjiu* (Studies on the Xiamen SEZ).
XSB --- Xiamen Statistical Bureau.
YCSEZ --- Yearbook of China's Special Economic Zones.
YJ --- *Yuang Jian* (Global Views).
ZGJJWT --- *Zhongguo Jingji Wenti* (China's Economic Issues and Problems).
ZGSHKX --- *Zhongguo Shehui Kexue* (China Social Science).

CHAPTER 1 INTRODUCTION

The 1980s was not only a decade in which many developing countries adopted a series of major economic policy reforms, but also a historic period in which all socialist and the formerly socialist countries, with apparent exception of Cuba and North Korea, undertook varying degrees of radical reforms in their Soviet-type, centrally planned economies. While the reforms in the former case were carried out often as part of the structural adjustment programmes attached to the lending conditionality of international financial organisations, such as the World Bank and International Monetary Funds (IMF), the restructurings in the latter case were based largely on the realization that market forces or market-like mechanisms are more efficient than command mechanisms in allocating and utilizing resources.

Emerging from nearly three decades of isolation, the People's Republic of China (PRC), as a both developing and socialist country, has so far positioned herself largely in the mainstream of the reform of the 1980s. China's economic reform and "open-door" policy have not only produced significant changes in its domestic economy but also exerted a profound impact on the Asia-Pacific and indeed world economies as well. In the meantime, the unique Chinese reform and opening experiences have attracted more and more attentions from the international community and become one of the most important areas of contemporary Chinese studies.

1-1 In What Way Does This Thesis Build on Previous Researches?

The establishment of China's first four Special Economic

Zones (SEZs) in 1980 and the fifth in 1988 and their subsequent development have spawned a booming academic research on them both within and outside China. In China, articles, books, yearbooks, and edited volumes on the SEZs are abundant, as indicated by the country's most comprehensive bibliographic index, *Quanguo Baokan Suoyin*. At the same time, researchers in Hong Kong (and few in Taiwan) have also produced a number of substantive works on the SEZs. All these Chinese-source studies have provided a great deal of first-handed information and insightful analyses. As they will serve as important references throughout this thesis, they are not investigated here.

The English-language literature on the SEZs, on the other hand, has been published predominantly by Western (and some by Hong Kong) scholars.[1] According to Crane (1990), the work has been focused on two major aspects: fist, the actual economic achievements, which show, on balance, "a sub-optimal performance;" and second, the evolution of zone policy, which emerges as "inconsistent," ambiguous ("never very clear"), and unpredictable ("changing unexpectedly") (pp. 5-6). As a result, most authors tend to attribute the less than satisfactory economic performance to the policy problem.[2]

The above conclusion may be correct, but the studies that give rise to it do not go further to explicate the causes of the policy problem. Although Crane (1990) makes some noteworthy contributions in searching the reasons from the perspective of China's political economy, in particular "the

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[1]. For major English-language publications on the SEZs, see Stoltenberg (1984); Sit (1985); Wong and Chu (1985); Oborne (1986); Jao and Leung (1986); Falkenheim (1986); Pepper (1986); Wong (1987); Battat (1987); Harding (1987); Wong (1987); Hsueh and Woo (1988); Sit (1988); Crane (1990) and (1992); and Wall (1992).

Among the best journalistic sources in English on the SEZs are the *Far Eastern Economic Review; China Trade Report; The Asian Wall Street Journal; Beijing Review*; and *The China Business Review*.

[2]. For a typical view, see Hsueh and Woo (1988), pp. 509-10.

relationship between political structures and zone problems" (p. 8), it has not made the task of searching economic reasons any easier.

In addition, the previous researches seem to have two other major defects. First, they tend to approach the SEZs in the context of EPZs and pay inadequate attention on the special circumstances of China's changing economy [typically, Sit (1988)]. In other words, they are unable or neglect to study the SEZs in the context of the Chinese economic reform and "open-door," in particular to search the reasons for zone problems from the interaction between the SEZs and the domestic economy. As a result, the analyses are concentrated mainly on the gains or losses in areas like size of foreign capital inflow, employment creation, exports, foreign exchange earnings, tax revenues, and technology transfer, but rarely on issue such as the interrelationship between the development of the SEZs and the domestic economic reform. In doing so, they have failed to explore an important area of SEZ study --- the experimental function of the SEZs serving as a "laboratory" for the Chinese domestic economic reform.

Second, the previous researches in most cases focus only on the Shenzhen SEZ, the flagship of China's SEZs, due partly to its much publicized "spectacular success" and partly the comparatively easier access to the information of it. However, the SEZs are quite different in terms of socio-economic legacies, geographical conditions, resource endowments, and the level of current economic development, and hence have exhibited different features and patterns in the process of their development. By concentrating mainly on Shenzhen, the researches can, therefore, hardly represent the whole picture of China's SEZs.

In short, the previous studies provide only a rudimentary understanding of the complexity and diversity of the SEZs. More work needs to be done in searching the reasons for the policy problem in the SEZs and assessing the effectiveness and significance of its experimental function as a reform "laboratory." The tasks may have to be done by expanding the

research scope into other SEZs in order to get more representative and accurate findings on the SEZs.

1-2. Goals of This Study

This thesis, therefore, intends to open up a new area of the study on China's SEZs, by 1) answering the two important questions raised but unanswered by the previous researches and 2) shifting the research focus from the traditional target, the Shenzhen SEZ, to a new one, the Xiamen SEZ --- "the second most important" one, according to Crane (1992: 848). It is to conduct a comprehensive and systematic case study on Xiamen in order to find out the reasons for the problem of policy inconsistency, ambiguity and unpredictability in the SEZ and to assess the effectiveness and significance of the SEZ's experimental function. It is hoped that the findings from this study will greatly advance the understanding of the characteristics and problems of the reform and openness in China in general and in the SEZs in particular.

A new analytic approach will be adopted, whereby the analysis of a Chinese SEZ will be conducted in the context of not only EPZs, as done by most of the previous researches, but also China's ongoing reform and "open-door." More specifically, not only the relationship between the local economic development and FDI in Xiamen but also, for the first time, the one between the economic reform and the Special Policy, and the one between the SEZ and the Chinese domestic economy are to be examined in this thesis.

1-3. Why Xiamen?

To date, only modest efforts have been made in studying the Xiamen SEZ, both within and outside China. They include a number of articles published in newspapers and journals, and one conference report edited by the National Centre for Development Studies, the Australian National University (Brogan, 1988). But like other studies on the SEZs, they

provide no answers toward the questions regarding the policy problem in the SEZ and the effectiveness and significance of its experimental function.

Xiamen, located in the south of Fujian province, is the only SEZ converted wholesale from the original city (*Xiamen Shi*), which had already had more than three decades of economic and social development under the People's Republic. The other three SEZs in Guangdong province were all built on scratch, either on remote, rural boarder areas (in cases of Shenzhen and Zhuhai) or in the outskirts of a city (in case of Shantou). As a result, Xiamen exhibits three unique features:

First, it is a typical small- and medium-sized industrial city in China, with all its well-established political, administrative, economic, and social structures in place. This implies that it, inevitably, still maintains substantial, if not close any more, links with domestic markets, institutions and policies. Not surprisingly, in 1988 the State Council designated it, together with other sixteen cities, as a "pilot city for the comprehensive urban reform" (*Zhonghe Chengshi Gaige Shidian Chengshi*).

Second and related, it possesses an all-round but underdeveloped industrial base, which contains about 588 largely public-owned and technologically outmoded enterprises with about 45,000-strong workforce. This means that Xiamen, like many Chinese cities, faces the formidable task of transforming the irrational industrial structure and inefficient enterprises.

The above two special features indicate that Xiamen is an ideal object for the investigation on how the reform of China's Soviet-style planning and management system, together with its old, inefficient industry, is carried out in a SEZ, at both the macro- and micro-levels. This should provide a opportunity for one to explore the relationship between the reform and the Special Policy and the one between the SEZ and the domestic economy.

Third, it is a historic trading seaport and has extensive and close trade links with all over the world, especially with

Taiwan, Hong Kong and the Southeast Asia. In recent years, it has become the focus of Taiwan direct investment (TDI) in mainland China. Indeed, Taiwan capital is transforming the SEZ's economy. This special feature suggests that Xiamen is the most appropriate place to carry out a study on the effects of FDI, especially TDI, on the local economic development, as well as the economic link between the PRC and Taiwan.

Thus, it is not an exaggeration to say that the Xiamen SEZ encompasses all of the complexities and difficulties of China's reform and "open-door." This makes it a perfect object for the assessment of the effectiveness and significance of a SEZ serving as a "laboratory" for the industrial reform and foreign economic development.

1-4. Unique Contributions of This Study

This thesis will examine three important topics which, deriving from Xiamen's special features, are not only essential to Xiamen's development but also have significant implications for the country's ongoing economic reform and "open-door." They are Xiamen's enterprise reform; utilization of FDI, especially TDI, in connection with the local industrial transformation; and the relationship between its foreign trade liberalization and its price reform during its first decade of the 1980s.

The significance of this study may be highlighted at least by the following four unique and important contributions it is to make to the research on the SEZs and other related fields.

First, it is the first special, comprehensive and systematic case study on the Xiamen SEZ, and hence will undoubtedly widen the scope of the existing researches on China's SEZs. In particular, it will enable people to observe and analyze how a socialist country restructures its Soviet-style, command economy in a small, market-oriented policy enclave.

Second, it is the first serious attempt to link the

analysis of the SEZs with the changes and developments in the Chinese domestic economy, or more specifically, to search the causes of the problem of zone policy from the interaction between the development of the SEZs and the domestic economic reform. In particular, the examination of the Separation of Tax and Profits in Chapter 5 is the first, at the time of writing, detailed study on the enterprise reform programme conducted in English language. Consequently, this will, on the one hand, add one more dimension into the growing knowledge of the effects of China's domestic economic reform and, on the other hand, increase the understanding of the experimental function of the SEZs.

Third, it is the first detailed case study on the effects of TDI on the PRC economy, particularly on the local industrial transformation. This will certainly help the discussion of the increasing economic link between the PRC and Taiwan and indeed may shed light on the development of the so-called "Greater China Economic Areas," consisting mainly of the PRC, Taiwan and Hong Kong.

And finally, due to the multi-faceted nature of the Xiamen SEZ, the study on it will inevitably link China's experience to those of developing countries striving for industrialization, countries using the device of EPZ, and reforming socialist and the formerly socialist countries. As a result, the study is bound to make valuable contributions to the study on each of these areas.

1-5. Literature Review and Historical Background

The theoretical perspective for this thesis is derived from the growing literature on the industrialization and economic policy reform in developing countries, especially the Neoclassical approach; the development of EPZs; and the economic reforms in the formerly socialist economies. It is believed that a brief examination of relevant views, policies, changes and developments in each of these areas will provide a proper analytic context for the discussions of the Chinese

present reform and openness in general and the development of the Xiamen SEZ in particular.

1-5-1. Alternative Theories of Industrialization and Economic Reform in Developing Countries[3]

For at least three decades, industrial and trade reform has been high on the policy agenda of many developing countries striving for industrialization. Macro imbalances and micro inefficiencies have forced them to reconsider their policy towards industry and trade. In general, there are *three* major alternative theoretical approaches to the policy. They are *Structuralist, Radical* and *Neoclassical*.[4]

Structuralist Approach

The Structuralist school, seen as representing the conventional wisdom on developing countries in the 1950s and 1960s, contends that the structure of an economy, particularly the size of its industrial sector, is a key determinant of the long-term growth. It covers a wide range of authors, notably Paul Rosenstein-Rodan, Ragnar Nurkse, W. Arthur Lewis, Paul Prebisch, Hans Singer, and Gunnar Myrdal. Among key characteristics, the belief that development is a process of major structural transformation with manufacturing industry having a crucial role to play, is the most prominent one. Central to this argument are two important concepts: *externalities* and *linkages*.

Externalities can be defined, according to Scitovsky (1958), one of the best classic article in this regard, as the effects created by individual producers or consumers, that are incurred and received by other producers or consumers but are

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[3]. The following discussion draws mainly on Todaro (1982), Weiss (1988) and Meier (1989).

[4]. This categorization is now used regularly in text-books of development economics (e.g. Herrick and Kindleberger, 1983; and Weiss, 1988).

not taken into account by the original creators of the effects.[5] It is important to understand that the net benefits of externalities, where they exist, to the economy as a whole can be quite different from those accruing to private producers. In addition, the existence of externalities has to a large extent justified the need of appraising investments from a broad economic perspective and of planning and coordinating investment activities (p. 301). To rationalize the greater potentiality of industry in generating external effects, however, one must rely on the concept of linkages.

Hirschman (1958) defines linkages as an inducement mechanism whereby the activity of one firm is created by the actions of another. He has also distinguished two types of production linkages --- *backward linkages* from a particular industry to its input suppliers and *forward linkages* from an industry to its output users.[6] Both linkages, reflecting production interdependence, can be used as a mechanism to transmit externalities. In general, the activities with the highest linkage effects tend to have the greatest potential for creating externalities.[7] This enables planners in developing countries to assess the consequences of different patterns of investment and thus to choose the leading industrial sector and the optimal form of expansion.

Central to the Structuralist position is the view that externalities are more significant in manufacturing industry than in other major sectors, such as agriculture and services. This is because manufacturing can generate much greater linkage effects both within the sector itself and on other sectors, and thus has the potential for greater positive

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[5]. Scitovsky divides this broad concept further into *Technological Externalities* and *Pecuniary Externalities*. For details, see Scitovsky (1958).

[6]. Albert O. Hirschman has later broadened his linkages approach by going beyond production linkages of input-output character to consider consumption and fiscal linkages. See Hirschman (1977).

[7]. Of course, not all linkages generate desirable externalities.

externalities. Using an input-output table, Yotopoulos and Nugent (1973) assesses the linkage potential of different branches and the result has confirmed the above conclusion.[8] Young (1928) provides an excellent explanation of this situation. As manufacturing is increasingly characterized by interrelated and specialized branches of activities, it has the potential for a high degree of "roundaboutness" in its production structure. This means that when its aggregate output expands there is far greater scope for labour division and specialization within the sector itself, than is the case for other sectors. Further, manufacturing is the sector which produces the capital goods and other machinery equipment used by other sectors. A strong machinery (or engineering) sector is essential for initiating and transmitting technical and productivity changes, since its growth will also raise productivity in other major sectors through their purchases of capital and intermediate goods and the transfer of knowledge between machine makers and users. That is why Kaldor (1967) sees manufacturing as an engine of growth.[9]

Radical View

The radical analysis approaches industrialization from a wider political-economy perspective. Despite varying degrees of modification to its classical Marxian approach in the last 30 years or so, It can be described as "that which is highly critical of capitalism, favours socialism, and often employs Marxian analysis" (Griffin and Gurley, 1985: 1089). Its most distinct and influential approach to development issues is the "Dependency Theory," which views developing economies as part of the world capitalist economy, whose current economic, social and political conditions have been determined by

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[8]. See Table II in Yotopoulos and Nugent (1973), p. 163.

[9]. Some Structuralists have done some empirical work on the role of manufacturing in developing countries. See, typically, Brailovsky (1981), which examines the Mexican growth in this perspective.

contact with the advanced capitalist economies. Consequently, much of the Radical literature emphasises the obstacles to and limitations of industrialization in developing countries under existing international and domestic systems. Although some of these arguments, particularly those on the role of transnationals and their relations with the state and local capital, raise important policy issues, the conclusion that capitalist industrialization in developing countries is deemed to be distorted or blocked appears to be unconvincing.

Neoclassical Perspective

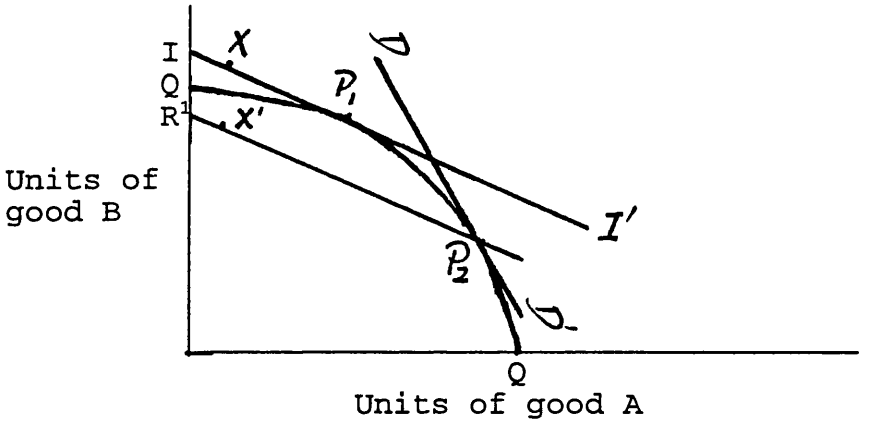
The Neoclassical approach to development has become increasingly influential since the 1960s and 1970s. The central tenet of this school is, as defined by Ian Little, one of the foremost representative of this school, A) a belief in the effectiveness of the market mechanisms as a means of allocating resources, and B) an emphasis on the potential gains from participation in world trade (Little, 1982). As a result, the school's critique of the industrialization policies in developing countries focuses on two important aspects: 1) the government interventions have stifled the operation of the market and contributed to an economically inefficient form of industrialization; and 2) the trade policies and patterns have reduced export growth and ignored specialization on the basis of comparative advantage. An economically rational industrial policy, it is argued, is one which removes both of these sources of inefficiency.

In general, the Neoclassical position sees government intervention in the operation of the market, using such policy instruments as tariffs, quantitative import controls, minimum wage legislation, budgetary and credit subsidies, controlled interest rates, and indirect taxes, as the main reason for the distortion of prices. At the same time, trade policy is seen as a key component of industrial policy since it has a major influence on the pattern and pace of industrial development. As industry generally produces tradable goods, exposure to

foreign competition is viewed as essential to stimulate efficiency gains. Trade reform is therefore central to the success of industrial reform. Hughes (1992), representing the current orthodox Neoclassical position, argues that market reform, including trade liberalization, will create a stronger industrial sector in developing countries. As a result, the Neoclassic school argues strongly for introducing market-oriented reforms and in particular trade liberalization.[10]

Arguments for Market-Based Reform The underlying reasons for market and trade reforms can be represented diagrammatically using the standard production possibility frontier in a two-commodity model.[11] Figure 1-5.1 shows an economy producing two goods, A and B, both of which are internationally tradable, and the combinations of A and B that

Figure 1-5.1 Allocative costs of protection



can be produced on the frontier QQ given domestic resource and technological constraints. II′ is the international price line that prevails under free trade, while DD′ is the domestic price line with some form of trade barrier. P_1 is the efficient production point on the frontier under free trade,

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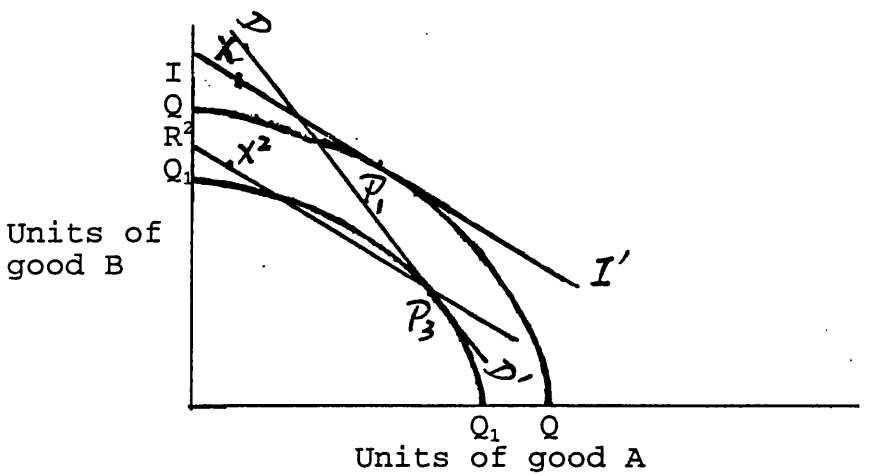
[10]. For more influential arguments of the Neoclassical case for industrial reform, see Little *et al.* (1970), Corden (1974), Balassa (1982a), Little (1982) and Krueger (1984).

[11]. The following discussion draws on Adhikari, *et. al.* (1992), pp. 4-6, with modifications.

while trade along II′ allows a combination of goods X to be attained. On the other hand, P_2 is the production point under protection, and trade along II′ under this restricted conditions will allow a lower combination of goods X^1 to be obtained. Thus the allocative efficiency loss in terms of Good B is given by R^1I on the vertical axis. Here the production under protection may still be on the frontier but it is at the sub-optimal point.

The more significant cost of protection in developing countries, however, often derives from the loss of potential output because either of rent-seeking behaviour (bribery and lobbying etc.) to get favourable treatments from a control system, or of the negative incentive effects of protection, which induce X-inefficiency and raise unit costs (Bhagwati, 1989). Either effect will, as shown in Figure 1-5.2, cause the production possibility frontier moving inwards to Q_1Q_1. This means that production now can only be at point P_3 and trading along II′ allows the combination of goods X^2. Compared with the free trade position, the total loss of goods in terms of B is now R^2I on the vertical axis.

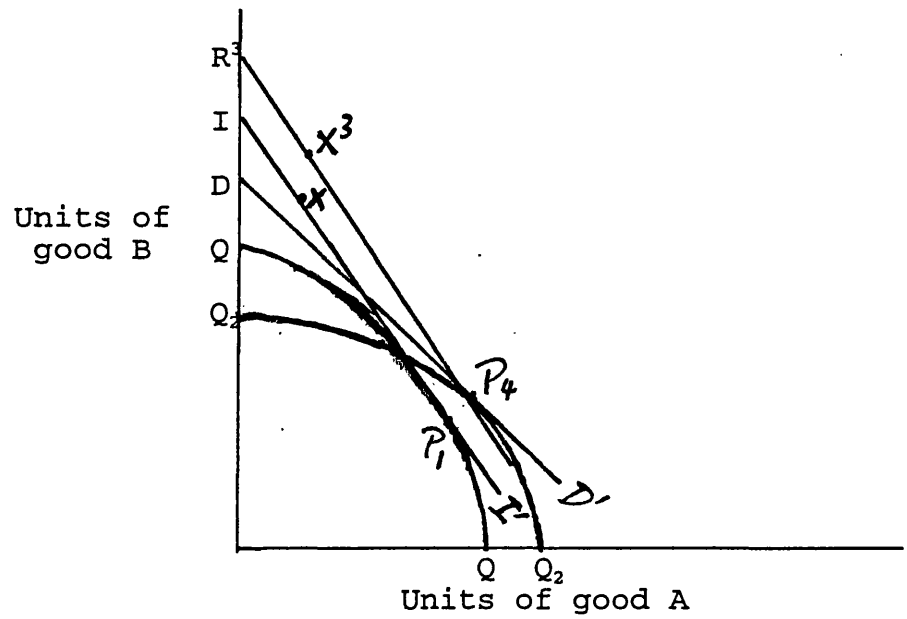
Figure 1-5.2 Total costs of protection: allowing for rent -seeking and incentive effects



Trade liberalization in a protected economy can lead to both an outward shift in the frontier, if it creates genuine dynamic benefits, and an inward shift, if it results in the closure of some inefficient industries. This situation can be

demonstrated in Figure 1-5.3, where a new frontier Q_2Q_2 is created with production of Good A expanding while B contracting. This implies that the country's comparative advantage has changed and now lies in A. Production under semi-reformed trade system is at point P_4 and trading along II' allows a combination of goods X^3, which is above the original free trade combination of X. Thus the gain from trade reform in a protected economy in terms of Good B is R^3I on the vertical axis. What is significant here is that a higher frontier has been achieved.

Figure 1-5.3 Gains from trade liberalization under protection



Thus, Neoclassical authors see market liberalization and moves towards freer trade as critical to improvement in the efficiency of industry. Liberalizing markets means, among other thing, the removal of government controls on prices and an end to government direct interference in enterprise businesses. Freer trade, on the other hand, could bring greater competition with resulting productivity gains as producers are forced to compete internationally. The authors may disagree among themselves on the exact details of reform policy, but they generally have same views on the overall outline of reform. It includes the following main aspects:

- deregulation of factor markets and the removal of price and other controls on enterprises;
- a major reduction in government expenditure and the general role of government in economic activity through privatization programmes or by phasing out subsidies to unprofitable state-owned enterprises (SOEs);
- removal of quantitative barriers to trade and the rationalization and reduction of tariffs on imports;
- devaluation of exchange rate;
- encouragement of foreign direct investment.

In addition, it has also been recommended, based on the reform experiences in the Latin America, that the timing and sequence of reforms be influenced by the current condition of an economy, such as whether it is suffering from inflation, in recession, or vulnerable to external shocks. It has been widely accepted, for example, that the liberalization of the capital account of the balance of payments should be phased to follow trade liberalization with a substantial time lag. This is designed to avoid the possibility of major capital inflows leading to an appreciation of the real exchange rate, which could jeopardise the fundamental goal of such reforms by penalizing new export industries. Also, the question of the appropriate mix of macro-economic policies accompanying market reform has been noticed. It involves complex issues of coordinating various aspects of macro-economic management, such as price stabilization, adjustment of interest rate and exchange rate, and credit control.

Trade Reform Policy The Neoclassical discussions of patterns of trade specialization contain a simple descriptive sequence of stage illustrating alternative trade strategies: primary import-substitution; primary export-substitution; secondary import-substitution; and secondary export-substitution. The school generally favours the strategy of export-substitution, where the share of new manufactured exports increases in total exports. The Neoclassical view on

trade strategy is not that developing countries should remain as permanent exporters of labour-intensive goods, but that it may become economically beneficial on a certain stage of their development to diversify the structure of their exports. For example, if a country has already set up a relatively comprehensive and sophisticated industrial base, export of not only primary but, more importantly, secondary products should be encouraged.

Having realized that the level of protection in most developing countries was both excessive in absolute terms and highly discriminatory in its impact on other sectors, Neoclassical authors generally agree that levels of protection should be both reduced substantially and made more uniform between different activities.[12] Specific reform measures include:

- reduction in both the level and the variability of import tariffs;
- abolition of import quota protection;
- introduction of export subsidies where necessary to offset the effect of whatever import protection remains;
- devaluation of exchange rate;
- continuation of some modest protection for key activities, which can be phased out gradually.

The experience of the four East Asian NICs, argued by some Neoclassical authors, has demonstrated the potentiality of the export-substitution strategy, which is associated with the removal of incentives biased against exports. Indeed, the four NICs' export-led growth based on labour-intensive manufactures at a relatively early stage of industrialization has, in their view, become a model for other developing countries to follow (e.g. Krueger, 1985).

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[12]. Balassa, for example, has been one of leading advocates of trade reform along Neoclassical lines. Others include Little, Corden and Krueger. For their representative works, see Footnote 10.

Relevance of the Theory In recent years, the Neoclassical economic theory has come to be linked with stabilization and adjustment programmes introduced in developing countries. These reform efforts were designed not only to reduce the share of the state in economic activities so as to allow the market to function more freely, but also to control inflation primarily through monetary policy. Many powerful international organisations, such as the World Bank and the IMF, have been influenced by the Neoclassical position. Indeed, the policy advice they offered to governments and the reform programmes they imposed on countries as loan conditionality have been based largely on the "market paradigm" emerging from the Neoclassical tradition of development economics (Little, 1982).

Of course, this does not mean that the Neoclassical case for economic reform can simply be seen as the blueprint for reform. In fact, few reform packages introduced so far really followed the theoretical recommendation precisely. While its concern over the lack of prices and the functioning of the market in many industrial programmes remains valid, reforms emphasizing on the dismissal of the role of direct government intervention are not necessarily an adequate basis for successful industrialization. Indeed, the empirical experience of the NICs casts a doubt over the claim made by some Neoclassical authors that the success of their economies could been seen as a example of reducing government role significantly and allowing the market to function more freely (e.g. Little *et al.*, 1970; Balassa, 1981; Lal, 1983; Linder, 1986, cited in Nolan, 1993: 57).[13] Experiences in many other countries also suggest that market forces alone should not be left to determine the size, composition and characteristics of

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[13]. In fact, quite a number of authors argue that the success of NICs is a "special case" in terms of both supply and demand side conditions, which rend their experiences of little value as models for other developing countries (e.g. Lewis, 1980; Streeten, 1982; Cline, 1982; Hamilton, 1983, cited in Nolan, *op cit.*: 57). For a brief summary of these arguments, see Nolan, *op cit.*, pp 60-5.

a country's industrial sector. In other words, most governments in developing countries ought to pursuit an active industrial policy to influence industrial development process and indeed "intervene strongly in the workings of the market," using both price and non-price policy instruments, "if socially desirable outcomes are to be achieved" (Nolan, *op cit.*: 197).

None the less, this weakness will not in any way nullify the Neoclassical school's profound contribution to the debates of industrial and trade policy in developing countries. In fact, many of its arguments for introducing market-based reforms are applicable not only to developing countries with market or mixed economy but also to those with Soviet-style, centrally planned economy, such as China's. As a developing socialist country, China shares many common characteristics in the economic system with other developing countries, particularly those with the combination of a weak private sector, political monopoly, heavy policy-induced distortions and macroeconomic imbalance. Also, much of the Neoclassical critique of inward-looking industrialization strategy is also relevant to the Chinese development experience prior to the reform. Indeed, the current Chinese economic reform is, according to Perkins (1988), "in many respects similar in nature to" the economic liberalization under way in a number of developing countries in 1970s and 1980s. They share the same fundamental objective --- "to reduce the hold of the government bureaucracy over the economy and to replace bureaucratic direction with the impersonal forces of the market." The main difference between China and other developing countries is "the distance it must travel to reach some form of a market system." This is due to the fact that the "Soviet-style central planning involves more or less complete bureaucratic control over industry and even much of agriculture, while most developing countries have a mixture of centralized planning, bureaucratically manipulated markets, and markets that are free of bureaucratic manipulation (p. 603).

At least three of Neoclassical fundamental positions seem to be particularly instrumental to the Chinese reform and the "open-door" policy. First, the importance of reducing the role of government in directing economic activities and increasing the effectiveness of policy intervention through price mechanisms instead of administrative means. Second, the importance of increasing export possibility and of granting equal incentives to both exporters and import competing producers. And third, the importance of encouraging foreign investment where it provides either capital, technology, management or marketing network, that would otherwise be lacking or available at higher costs.

1-5-2. Development of Export Processing Zones

Since the late 1960s and early 1970s the export-led growth policy has increasingly been adopted by developing countries and regions as their principal industrialization strategy. Many of them have established various export-oriented enclaves, usually referred to as Export Process Zones (EPZs), in the drive to stimulate their exports, especially manufactured exports. The creation of China's SEZs is widely seen as the attempt by the Chinese authorities to emulate the success of the EPZs and free trade policy in the NICs and other Southeast Asian countries. Thus, in view of the growing trend of EPZs being used as instruments of the trade and industrial policy in developing economies, it is important to examine the characteristics of EPZs, analyze their performance records in terms of the contributions made to export and industrial development, identify the problems arisen from their development process, and to draw lessons from the past experiences.

Characteristics

The EPZ can be defined as "an administratively and sometimes geographically delimited area, enjoying special

status allowing for the free import of equipment and other materials to be used in the manufacture of goods earmarked for export. The special status generally involves favourable legal provisions and regulations pertaining mainly to taxation, both of which constitute incentives for foreign investment."[14] Hence, it generally has four main characteristics:

- It is an "enclave" enjoying a status that does not extend to the whole territory of the country;
- Time-consuming customs procedures on import into it and export from it are kept to a minimum;
- Enterprises set up there must export their products;
- Foreign investment is generally expected to provide the main impetus.

The first EPZ was established at Shannon airport in Ireland in 1959, at a time when Ireland's industrialization policy underwent a change from import substitution to export-led expansion. By the late 1980s there had been about 130 EPZs and EPZ-type economic zones (including the SEZs) in some 40 developing countries and regions. The EPZ is therefore a relatively recent variant of the widely used Free Trade Zone (FTZ).[15] But in some countries EPZs and FTZs are combined in the same industrial estate, and thus the terms EPZ and FTZ are often used interchangeably.

EPZ basically represents a second-best type solution for a country wanting to benefit from a greater and more efficient

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[14]. This definition is based on UNIDO (1980) and UNCTAD (1985).

[15]. The FTZ, on the other hand, can be defined, according to the World Bank, as "a designated area, usually in or next to a port area, to and from which unrestricted trade is permitted with the rest world. Merchandise may be moved in and out of FTZs free of customs, stored in warehouses for varying periods and repackaged as needed. Goods imported from the FTZ into the host country pay the requisite duty; their prior storage in FTZ warehouses permits rapid delivery to order, meanwhile saving interest on customs payments" (Goderez, 1981: 7-8).

integration into the world economy without subjecting the country's entire economy to trade liberalization and deregulation. By removing tariffs and most other distortions (i.e. regulations) it is hoped that the factor intensity of production in zones will correspond more closely with the factor endowment of the host country, and thus that comparative advantages in this country can be exploited more efficiently (Spinanger, 1984: 65).

For foreign investors, mostly from industrialized countries, the major factor influencing their investment decision is the consideration of the cost and productivity of the labour force available in EPZs. For most developing countries, on the other hand, the objective of establishing EPZs tends to be multi-faceted. It generally includes: 1) attracting foreign capital and advanced technology; 2) acquiring and improving economic management know-how; 3) generating foreign exchange earnings; 4) creating employment opportunities; and 5) developing linkages between EPZ industries and the domestic economy.

According to Spinanger (1984), the general analysis of the impact of EPZs consists of two essential aspects: static and dynamic effects. The former effects, which can generally be measured, cover the costs and benefits directly emanating from an EPZ or from the linkages between an EPZ and the host country (or the foreign sector), while the latter effects, which can basically only be broadly outlined, refer to 1) the impact of an EPZ on the efficient allocation of the factors of production in the EPZ, and 2) the profound impulses created by the EPZ for the industrialization process of the host country as a whole in the form of linkages.

Thus, the static effects of an EPZ generally includes the development of employment, sales (exports), purchases (either from host country or imports), and the remuneration of factors of production. Obviously, a positive foreign balance, where exports exceed imports plus the transfer of profits or interest payments, is seen as a net benefit to the EPZ. At the same time, a positive balance vis-à-vis the domestic economy

is generally interpreted as a net benefit to the economy. In other words, the investment in infrastructure has been compensated by rents, wages and local purchases of capital or intermediate goods as well as services. The dynamic effects of an EPZ, on the other hand, basically include the changes in the structure of employment, production (value added) and exports as well as the factor intensity of production in both the EPZ and the host country as a whole for a certain period. As the comparative advantage for most developing countries lies in the use of the relatively more abundant factor of production - labour forces, the level of development (expressed as e.g. per capita income) can therefore be assumed as being negatively correlated with the labour intensity of production. Normally, linkages between the an EPZ and the host economy are expected to develop over time as the country's development level increases.

Performance Record[16]

While a few EPZs and EPZ-type zones/territories can be regarded as successful, particularly Singapore, Hong Kong, Kaoshiung (Taiwan), Masan (South Korea), Sungei Way, Bayan Lepas and Penang (Malaysia), and Mauritius, the overall performance of most EPZs in developing countries has, according to UNCTAD (1985), been "disappointing" (p. 4). Their contribution to the further economic development of the host economies has been insignificant, at least falling far below the rather ambitious objectives pursued by many of the governments. An OECD study criticize EPZs for having "many notable failures," accusing them of "leading to the wastage of already scarce resources in the host countries concerned" (Basile and Germidis, 1984: 22).[17]

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[16]. The data used in this section draw, unless cited otherwise, from UNCTAD (1985) and Rondinelli (1987).

[17]. It is therefore not surprising that international organisations such as UNCTAD and UNIDO, after warmly encouraging developing countries to set up EPZs on their

The contribution of foreign investment in EPZs to the capital stock of the host economies has been small. The capital investments made by foreign firms in EPZ production sites do not normally exceed $1 million and are, in many cases, below $500,000 (such as those made by Taiwan investors in mainland China). More frequently, investments made by the host governments and domestic sectors in EPZs, including both the construction and maintenance of major infrastructure projects and manufacturing activities, are far greater than those from the foreign source, though which is supposed to play a major role in the development of EPZs. The small scale of foreign investment also reflects the "footloose" character of foreign firms in EPZs.

Most EPZs have attracted non-complex industries which are usually vertically integrated into transnational corporations. Foreign firms are inclined to relocate labour-intensive stages of their production processes and/or operations involving mature or standardized technology in EPZs, reflecting their response to labour-cost differentials between developed and developing countries. As a result, major sectors of production in EPZs tend to be electronics, clothing, footwear, leather products, domestic electrical appliances, plastics, toys, sporting goods, optical goods, car parts, and minor transport equipment.

Recent studies indicate that EPZs and EPZ-type zones have provided about 3.5 million jobs, accounting for less than 3 percent of the total officially registered workforce in manufacturing industries, in all developing countries and regions. The majority of these jobs are offered to low-skilled manpower performing simple manual operations which can be mastered in a comparatively short time. Hence, their effects on improving the quality of the labour force have been minimal. Moreover, it is alleged that the job creation costs in EPZs tend to be high compared with those generated in agriculture or small- and medium-scale domestic industries.

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territory, subsequently became much more reserved and even extremely cautious in several cases (ibid: 23).

The foreign exchange earnings generated for the host economies by EPZ exports are the amount earned on domestic value added and, thus, generally limited to the EPZ wage bill and some additional charges paid by EPZ firms for purchases of local goods and services. In most cases, the share of EPZ exports in total manufactured and semi-manufactured exports is below 5 percent, while the share of domestic value added in EPZ exports does not exceed 25 percent. Of the domestic value added, the wage bill accounts for more than three quarters. Although tax revenue from EPZ firms would represent foreign exchange earnings for host economies, it does not accrue in many cases since host countries tend to offer foreign investors tax holiday for protracted periods, let alone the loss of taxable revenue, where taxes are paid, due to the manipulation of transfer price by the firms. Further, most foreign investors repatriate their profits earned in EPZs, instead of reinvesting in EPZs. As a result, apart from those in Taiwan and South Korea, few EPZs have managed to earned more than $10 million in foreign exchange.

EPZs have by and large maintained their enclave character and have not established any substantive linkages with the industrial sector of the local economies. Procurement of local tradeable production inputs by EPZ firms tend to be insignificant. The industrial activities in zones have not created a trained workforce which would be available for work in the domestic industrial sector when it leaves the zones. In particular, the differences between production processes in EPZs and in domestic sectors have further constrained the development of learning and demonstration effects in the host economies. Nevertheless, some aspects of foreign enterprise management ethics, such as discipline in production, respect of deadlines, striving for quality and spirit of innovation, have certainly exerted a propulsive influence on the local workers in EPZ firms.

It is generally very difficult to evaluate technology transfer, if it ever takes place at all, because, *inter alia*, of the various forms it takes. However, there are reasons to

be sceptical as to the effectiveness and significance of the technology transfer made both within EPZs and between EPZs and the host economies. The first reason is the strong vertical integration of the production process in the export-oriented industries, which generally favour routine activities, often highly automated, and hence offering little chance of improvement for the labour forces involved. The second reason is non-complex sectoral structure in EPZs. The industries most likely to bring about technology transfer are those producing capital goods and intermediate products, such as machinery, electrical and transport equipment, industrial chemicals, metallurgy and rubber. But, as described above, very few of these industries have EPZs managed to attract and develop so far. Thus, it is fair to say that the effects of technology transfer on both EPZs and the host economies have been very limited.

Lessons

Several important lessons can be drawn from the experience of the development of EPZs:

First, the location of EPZ is important not only for the development of the linkages but also for the macro-economic profitability of the venture itself (Spinanger, 1984: 84). In general, EPZs should be established in agglomerated areas (such as Penang in Malaysia), where agglomeration economies can be tapped and complementary infrastructure facilities are readily available.

Second, EPZs must be embedded in an appropriate national macro-economic policy framework in order to be used successfully as an efficient instrument in the industrialization process (ibid). The success of the EPZs in Taiwan and South Korea can be attributed largely to the sound policy environment created by the host governments. Of course, the availability of entrepreneurs and political stability is equally crucial.

Third, the tax and financial incentives offered by EPZs

to foreign investors are in many cases unnecessary. It is important for EPZ authorities to find an ideal balance between granting advantages regarded as adequate from the investor's point of view and minimising the costs in terms of revenue lost by the host authorities. In fact, simple and speedy administrative procedures and comprehensive and effective legal provisions are often more attractive to foreign investors than financial incentives.

Fourth, the device of EPZ in a predominantly inward-oriented economy are neither a panacea nor a sufficient measure to promote the efficient integration of the economy into the international division of labour (ibid: 85).

And finally, EPZs should be set only *one* principal objective, and should not be saddled with several --- any contribution they make to other objectives should be regarded as desirable externalities (Wall, 1976: 489).

1-5-3. Reforms in the Formerly Socialist Economies

The 1980s is an epoch of crisis and reform for almost all socialist economies. Countries like former Soviet Union, former East Germany, Hungary, Poland, Czech, Slovak, Bulgaria, Romania, and Albania have, after political revolutions, decisively embarked on the road to a free market or market-based economy. Others such as China and Vietnam have, while preserving the state monopolies on political power, social ownership and the savings-investment process, instituted varying degrees of radical economic reforms. However, China's economic reform, both past and present, shares many similarities with those carried out by the Soviet bloc countries during their pre-revolution period. Thus, it is important to examine the essential features of the Soviet-type economic system, the history of and the lessons drawn from the economic reforms in the former Soviet Union and East European countries during the communist era in order to put the understanding of China's present reform in an appropriate international and historical context.

Characteristics of the Soviet-type Socialist Economic System

The traditional socialist economic system, or centrally planned system, generally refers to the allocation of resources through a central plan: that is, the setting by government officials of mandatory production, exchange and distribution goals, and the procedures for attaining those goals, which are normally expressed in physical, technical and financial terms and enforced primarily by administrative methods. All significant means of production and distribution are government-owned, either directly (nationalization) or indirectly (collectivization) (Prybyla, 1990: 59). It was first set up in the USSR in the 1930s and adopted by the East European countries and China in the late 1940s and early 1950s. It had once produced impressive achievements in these countries: the rapid industrialization of the backward economies, the build-up of military power, survival in a hostile environment, victory in wars; substantial improvements in standards of education, health, social and private consumption; full employment of labour; price stability; and the development of natural resources, science and technology (Nuti, 1981).

At the macro-level, the hierarchy of a typical Soviet-type central planning has the State Planning Commission (SPC) at its apex, branch ministries at its intermediate level and enterprises at its base. The Communist Party plays, as in other walks of life, a crucial role in formulating and implementing policies and plans. The SPC receives instructions about basic economic magnitudes from the Party (especially the Politburo). These instructions are relayed via the state apparatus (especially the Council of Ministers) and the SPC combines these with the information flowing upwards from the hierarchy to draw up plans of varying duration by means of "material balance."

Prices for goods and services are set administratively and changed now and then to facilitate plan elaboration and help monitor plan implementation. Basic wages and salaries are

regulated by fixed wage scales set up for different categories of skill and effort. Industrial producer prices are fixed on a branch-wide cost-plus basis. Capital is centrally allocated and investment funds are normally provided in the form of grants. The exchange rate plays insignificant role in domestic price formation. Foreign trade is conducted by special export-import firms, and domestic prices are separated from international prices by a plethora of taxes and subsidies.

At the micro-level, a typical industrial enterprise is owned by the state, operating on the principle of "one-man responsibility and control" by a director appointed by the state or the Party. Enterprises generally interact *vertically* through their respective hierarchies rather than *horizontally* through markets. Their basic function is to fulfil their production plans. They are seldom liquidated as a result of inefficient production. By and large, competition is limited only to efforts at plan fulfilment. Thus, there is little incentive to innovation. Enterprises producing goods for exports or using imported commodities were shielded from the world market by the state monopoly of foreign trade and payments.

But this traditional Soviet economic system has many serious inherent defects. First, it has chronic *shortages* of both consumer and producer goods. The system has failed to provided people with increasing quantities and qualities of goods and services that the people want at prices they are willing to pay. Second, it results in enormous *waste*. The system fails to supply goods and services efficiently, or in other words, is statically inefficient. Third, it leads to *stagnant innovation*, both technologically and socially. The system fails to promote economic growth by improvements of factor productivity, or in other words, is dynamically inefficient (Prybyla, 1990: 18-21).

As a result, impressive production figures were often achieved at the expense of huge costs and the periods of reported high growth were normally followed by a stagnation or even decline in the rate of growth. In short, the socialist

economic system has never achieved the efficiency, productivity and related performance levels expected of it in the original socialist conception (Lee and Nellis, 1990: 2-3). By the 1980s, the performance of most of the socialist economies, except China, had by and large deteriorated.[18]

Reform Experiences

Attempts to reform the socialist economic system in fact began as early as the 1950s and have continued since that time. Although the reforms vary from one country to another in their timing, intensity, breadth and persistence, they do have certain elements in common. They were "conceived by the Party leadership as changes in the *economic mechanism* only, any impact on wider issues, especially the political system, was to be prevented" (Brus, 1979: 258). The planners sought to improve operational efficiency in their economies "by substituting market or market-like mechanisms for the command mechanisms of plan fulfilment and central physical allocation of inputs and outputs" (Lee and Nellis, 1990: 3). Thus, the invariant essence of the reforms was to decentralize some decision-making to the levels of the regional government and the enterprise. It was hoped that the devolution of economic authority would facilitate the transition, as the reformers saw it, from "extensive" to "intensive" growth (Knight, 1983: 11).[19]

The first country to make fundamental changes in the traditional model was Yugoslavia, after its expulsion from the Cominform in 1948. The economic reform within the Soviet bloc,

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[18]. For more details of the Soviet-type economic system and its defects, see further Wiles (1962), Nove (1969), Kaser (1970) and Knight (1983).

[19]. Knight classifies the decentralization into three types: administrative, economic and intra-firm. For more details, see Knight (1983), pp. 23-4.

however, did not start until the 1950s.[20] It took place in three waves: the 1953-60 period, the 1964-70 period, and from the late 1970s to the late 1980s. As the first wave of reform was relatively weak, the following discussion will focus only on the latter two.

Apart from the Yugoslav self-management movement and the Hungarian New Economic Mechanism, which represent a radical departure from the traditional Soviet economic system, there was a strong trend towards *organisational concentration* in other Soviet bloc countries during the second wave of the reform. Enterprises were amalgamated into larger-scale production units (often termed as "associations" and so on) in order to reap economies of scale, encourage technological progress and streamline the planning system by reducing the number of production units directly controlled by central planners.

In the GDR, in addition to the *VVB* (associations of nationalized enterprises), in which the functions of the supervisory body were interlined with that of enterprises, another amalgamated unit, the *Kombinat* (Combine), closer in status to an enterprise, came into being. In Hungary, amalgamated units took over the name of enterprises, which underlined the fact that the enterprise function, with all its enhanced autonomy, became vested in these units. In Poland, the whole idea of increased autonomy of industry was based on associations of enterprises, reorganised in such a way as to enable not only horizontal (branch) but also vertical integration. In Bulgaria and Czechoslovakia, the devolution of economic authority was accompanied by a substantial reduction in the number of intermediate units, i.e. by further concentration; a similar process took place in Romania, where the number of industrial associations (*centralele*) was reduced from 195 to 102. In Yugoslavia, the concentration took place in the form of mergers, with similar consequences.

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[20]. The following information is based largely on Brus (1979), Knight (1983), Section III, and Jeffries (1992), pp. 5-6.

At the same time, the number of indicators assessing enterprise performance was reduced and the emphasis put on profit and sales. Improved incentives included retaining a greater proportion of enterprise net revenue (for personal bonuses and investment) and applying more stable rules and parameters. Increased importance was attached to indirect steering of the economy via "economic levers," such as prices, the cost and availability of credit, and taxes. Wholesale prices were raised in order to reduce subsidies and tiered prices (fixed, range, and free categories) introduced. A closer link between internal and external economic activities was established, with foreign trade sector undergoing a series of reorganization.

However, the "second wave" was short-lived. The economic reforms soon lost their momentum and in most cases showed signs of retreat. The reasons included the Prague Spring (cracked down by the Soviet-led Warsaw Pact troops) and strong resistances from domestic powerful vested interest groups (like branch ministries) in each country. The piecemeal and modest changes proved inadequate to cure the deep-rooted problems.

The "third wave" was largely a decade of retrenchment. Further attempts were made at piecemeal reforms, with emphasis being put on making central planning more efficient. At the same time, planning techniques were improved, involving, e.g. integrated, computerized information and control systems to aid planning decisions. Gorbachev's accession to the Soviet leader in 1985 brought a new hope to the reform, but failed to solve any serious economic problem.

The major reason for the unsatisfactory result of the reform can be explained by the words of Zdzislaw Sadowski, former chairman of the Polish State Planning Commission: "All previous attempts to introduce reforms proceeded largely on the assumption that you could change part of the system without changing the whole" (Prybyla, 1990: 121-2). It only took the revolutions in East Europe in 1989 and the breakup of the USSR in 1991 to set course for a fundamental change in the

old Soviet-style economic system.

Lessons

The difference in the national experiences, plus the complexity of reforms involving entire economic, political and social systems, make it difficult to generalize the lessons of the reforms. But a few points can be made about factors which might be relevant to China's current economic reform.

First, "piecemeal" or partial reforms, incorporating some efficiency-promoting mechanisms of the market without changing the essential features of socialist economy, have generally not been successful. Indeed, according to Balassa (1982b), they may even have reduced economic efficiency by combining the negative features of centralized and decentralized systems (p. 308). That is why a World Bank study calls for "simultaneous implementation of an internally consistent and comprehensive (reform) package" (Knight, 1983: 107). In other words, "a linear sequence of individual policy change is not the right concept" and the issue of reform sequencing should be seen as "one of the *packaging* of reforms" (Fischer and Gelb, 1990: 29).

Second, as economic reforms inevitably affect the distribution of powers and incomes, they always encounter strong resistance from vested interest groups. Thus, a successful reform demands a powerful and persistent political backing. In particular, as reforms may temporarily lead to inflation and unemployment, without continued political backing and popular support they may not survive long enough to provide measurable benefits in terms of improved economic efficiency and living standard.

Third, enterprise reform is at the "heart" of socialist economic transformation (ibid: 22). The past partial reforms short of ownership change have proved insufficient to tackle the fundamental problems in SOEs, notably "soft budget constraints." A radical ownership reform requires privatization, which should be conducted in an orderly,

equitable and politically acceptable fashion. Joint ventures, involving private-private, private-public or domestic-foreign partnerships, have increasingly become a popular form of privatization in socialist countries (Lee and Nellis, 1990: 5).

Fourth, price reform is crucial to the overall success of economic reform given the important interdependence between the former and other aspects of the latter. It is widely agreed that the best way to rationalize the price system is to open the economy to foreign trade, thus exposing domestic producers and traders to world prices and foreign competition (Fischer and Gelb, 1990: 20). An appropriate price system is essential not only to trade liberalization but also to the hardening of budget constraints, since profits and losses are not necessarily good indicators of efficiency under distorted prices.

Fifth, the success of domestic economic reform in socialist countries depends heavily on the extent of opening their economies to foreign trade, capital, technology, and management. It is therefore important for the governments to develop a systematic approach to foreign investment and ownership, creating favourable administrative conditions and effective legal framework, as well as providing financial incentives, for foreign investors (ibid: 35).

And finally, the reform in socialist countries has been made more difficult by the fusion of the economy and polity. The Soviet-type economy is identical with politics. Thus, structural economic changes will inevitable demand concurrent changes in political structure, particularly the "leading role" (monopoly) of the ruling Communist Party (Prybyla, 1990: 121). A political reform is thereby needed to prevent the economic reform from being stalled by an entrenched bureaucracy, to bring about the recognition of the value of diversity and individual initiative, and to build up a substantial social and political consensus (Fischer and Gelb, 1990: 2; 13).

1-6. Structure of This Thesis and Explanation of Data

This thesis sets out to examine the reform and development of the Xiamen SEZ, its relationship with the domestic economic reform, and the effects of FDI, especially TDI, on the local industrial transformation during its first decade of the 1980s. Chapter 2 provides a detailed description of China's prereform, Soviet-style economic planning and management system; and Chapter 3 discusses China's present industrial and foreign trade reforms. The first two sections of Chapter 4 survey the utilization of foreign capital (especially FDI) and the development of the SEZs, while the third section characterizes the Xiamen economy, covering both before and after the 1949-revolution periods. Having provided the necessary theoretical and historical contextual background, this thesis starts dealing with the three important subjects in the following three core chapters. Chapter 5 examines the enterprise reform in Xiamen with an emphasis on the latest reform programme of the Separation of Tax and Profits; Chapter 6 analyses the utilization of FDI, especially TDI, in conjunction with the local industrial transformation; and Chapter 7 investigates the relationship between the trade liberalization and the price reform in Xiamen, with a special exploration on the relationship between trade development and inflation. And finally, Chapter 8 ends this thesis with summary and conclusions.

As actual experience with the Xiamen SEZ is relatively short, data about it are understandably scarce, fragmentary and sometimes even inaccurate. This of course prevents the author from making a more detailed survey on it. The study has therefore to be confined largely to the available official data, published mainly by the Xiamen authorities, such as statistical yearbooks, official survey reports, and a variety of development plans. It is widely agreed that the Chinese official data can be used with reasonable confidence, provided that one exercises adequate caution and, where necessary, rectifies some obvious bias or distortions. Some additional

information obtained from two field trips (in 1988 and 1991) will be used to complement, or provide a contrast to, the official data.

CHAPTER 2
CHARACTERISTICS OF THE PREREFORM CHINESE ECONOMIC PLANNING AND MANAGEMENT SYSTEM

The establishment of the SEZs in China in the early 1980s was not only a pioneering event among the centrally planned economies, but also the boldest step taken by the Chinese leadership in its bid to reform China's Soviet-type economic system since it launched the reform and "open-door" in the late 1970s. Obviously, the SEZs, especially the Xiamen SEZ, have to develop a new, market-oriented and outward-looking economic system on the basis of the old, centrally planned and inward-looking regime. Thus, a radical restructuring of the old system is vital for the success of the new one.

To comprehend the immensity and complexity of the Chinese economic reform and hence the nature of the problems faced by the SEZs in the process of their development, it is necessary to have a sound understanding of the old, prereform economic system. This chapter is, therefore, intended to feature the important aspects of it, with a view to providing a historical background for the detailed discussions of the present reform and "open-door" in China in general and the Xiamen SEZ in particular. Thus, Section 2-1 examines the origins and essential characteristics of the old industrial planning and management system, at both the macro and micro levels; Section 2-2 investigates the old foreign trade system; and finally Section 2-3 explores the major causes which eventually led to the present reform and openness.

2-1. The Industrial System

China's command economic system was basically established

in the mid-1950s under a particular historical circumstance. From 1949 to 1957, the Chinese Communist Party (CCP), with assistance of Soviet Union, brought about the rehabilitation of the economy, transformed the country's ownership of producer goods, and fulfilled the first Five-Year Plan (FYP). These events, together with some historic experiences of the CCP, had all contributed to shape the system.

2-1-1. The Origins of the System

In general, there are six important factors which had had direct bearing on the formation of the system:

1. *Imperative of Restoring Economic Law and Order* The economy the CCP inherited from the previous Nationalist (*Kuomintang*) government in 1949 can be best described as *chaotic*. Two decades of war destroyed much of the pre-existing industrial capacity, with production running only at 56 percent of its prewar peak level; while grain output, though less interrupted, was also estimated at only 70-75 percent of its previous best (Riskin, 1987: 33). Supply shortages led to chronic hyper-inflation and rampant corruption, which made the maintenance of normal economic transactions and daily life almost impossible.[1]

In short, the very severity of the chaos and depth of economic crises posed a severe test for the incoming government. In order to consolidate its military and political controls, it was vital for the new regime to swiftly rehabilitate production, stabilize prices and put an end to the deterioration of state finances. To accomplish these overriding tasks, the new communist government had, among other things, to acquire substantial physical and financial resources.

However, the resources directly controlled by the government in 1949 were extremely limited, and although it had seized a large quantity of assets owned by powerful

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[1]. For more details about the economic chaos in the late 1940s, see Liu Suinian and Wu Qungan (1986), Chapter 1.

capitalists hostile to the revolution and the new regime, the bulk of the economy was still in the private sector. Thus, it was imperative to put considerable resources under the direct control of the central government. Chen Yun, a veteran leader of the CCP in charge of economic affairs, put it explicitly: "the more acute the shortage of materials is, the more necessary it is for us to concentrate materials and use them to the best advantage" (Liu and Wu, 1986: 102).

Under this circumstance, the CCP drastically changed its economic management policy, from "unified leadership and *decentralized* operation" (*Tongyi Lingdao, Fensan Jingying*), developed in the communist-occupied areas during the wartime, to "unified leadership and *centralized* operation" (*Tongyi Lingdao, Jizhong Jingying*). The new policy contained "three centralization's:"

1). Centralization of state fiscal revenues and expenditures. All tax revenues, including agricultural taxes or public grains, tariffs, salt taxes, excise taxes, business taxes, and part of local taxes, had to be handed over to, and then allocated by, the central government.

2). Centralization of material distribution. All stocks of key raw materials in the country could be dispatched only by the Financial and Economic Committee or the Trade Ministry of the central government.

3). Centralization of cash management. Cash owned by all governmental and military organizations and public-owned enterprises had to be deposited in the People's Bank of China, the central bank, while rate-setting and allocation of foreign exchanges were also handled by the Bank.

The effect of this policy change was that from then on "the essential aspects of economic decision-makings were basically controlled by the Centre" (Zhou Taihe *et al.*, 1984: 15).[2] As a result, the centralized policy had played a crucial

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[2]. Some localities were reported to express their doubt on the appropriateness of this highly centralized policy, and indeed the central government also admitted that the new policy could cause "numerous difficulties" to localities. See Liu and Wu (1986), pp. 101-2.

part in restoring economic law and order and, more significantly, laid a foundation for establishing the central planning system.

2. *Development Strategy of the New Leadership* As soon as it took power in mainland China, the CCP firmly committed itself to two main objectives: 1). industrialization, and especially the development of heavy industry; and 2). elimination of the worst aspects of poverty. In the first case, the CCP leadership recognized that it could be attained only by building up an independent and comprehensive industrial capacity, which further necessitates a substantial increase in the rate of investment. Thus, centralized economic institutions were perceived as the only viable mechanism to achieve the required growth rate in overall investment and favourite allocation of a large portion of resources for heavy industry.

In the second case, the leadership pursued this objective by focusing on realigning the geographic distribution of industry and ensuring a more equitable distribution of government services. The communists considered the inherited pattern of industrial development, in which industrial output capacity was concentrated in the Northeast and a few major coastal enclaves, to be the result of over a half-century of foreign domination of the Chinese economy. Such regional disparities in the level of development were regarded as politically unacceptable in the long run.

Also, there was a virtual absence, in large areas of the country in 1949, of health care facilities, educational institutions, and other important social services. Accordingly, a centralized economic system was seen as the only effective means for redistributing resources to meet the government's goals to balance between the interior and coastal industrial development and improve distribution of public social services.

3. *Strong Influence of the Soviet Model* As the first communist state, the USSR was in many respects the only model for the PRC to follow. However, an even more compelling reason

for China to accept the Soviet assistance was that the USSR stood ready to support China in its industrialization. Soviet aid was especially effective because it was to be received in the form of plants, machinery, and systems of organization and management, which "inevitably resembled their counterparts at home" (Riskin, 1987: 59).

What appealed to the CCP leadership most was that the so-called "Stalinist Development Approach," i.e. the preponderant stress on the development of large-scale and capital-intensive producer goods industries, coincided with China's top priority at that time --- fast development of heavy industry. In addition, the organisational dimension of Stalinism, the highly centralized mode of command planning, the hierarchical "one-man management" system, and the highly articulated structure of individual material incentives in industry, were also relevant to China's acute needs.

As a result, China leaned to one side, and absorbed both the positive and negative aspects of Soviet experiences. In particular, the Soviet approach exerted a great influence on China's industrial and transport development pattern, planning and statistical systems, capital construction management system, material allocation system, and labour and wage management systems.

4. *Legacy of Wartime Practices* Before the founding of the PRC, the CCP had already developed an economic management system in their occupied areas, or "liberated areas" (*Jiefanqu*). Because these areas had long been surrounded by "enemy troops" and separated from each other during the decades of war, they adopted the policy of "self-reliance" and "self-determination" in economic affairs. They also developed a kind of communist supply system (*Gongjizhi*), in which provision of basic necessities for life was practised among military and administrative personnel. Obviously, the essence of the system, egalitarianism, had had a powerful influence on the formation of China's economic system.

Moreover, by the end of the Civil War, the CCP had become experienced in handling the problems of coordinating and

organizing military and logistic operations on a grand scale. In other words, the CCP's top policy-makers had been accustomed to working an enormous, complex and centralized organization. Deng Xiaoping testified that there had been an overall tendency towards centralization of power within the CCP since 1941 (Deng, 1984: 27-9).

In addition, there was also personnel factor. In general, the high-level administrators of the CCP came largely from, or had connection with, Northeast China, where a framework of a command economy, together with an infrastructure of a modern industrial complex, had taken shape one decade prior to the CCP's take-over in 1948.[3] The "colonization" of the planning and managerial sections of the top leadership by the Northeast Group (who had been associated with the building of the early version of the command economy) "sheds considerable light on the perpetuation of the administrative approach in subsequent periods" (Peter Lee, 1987: 44).

The Chinese admitted that their agricultural, financial, monetary, price (especially, those for agricultural and light industrial products) systems were established "on the basis of experiences gained in liberated areas, combined with considerations on the new situation after the liberation" (Zhou Taihe *et al.*, 1984: 61).

5. *Inheritance of Certain Measures Taken in the "Socialist Transformation"* Before the CCP could build up a Soviet-type economic system, there was still an important "prelude" for it to go through --- "socialist transformation of the private ownership of the means of production," that is, turning various private-owned sectors into public-owned ones (either state- or collective-owned) through nationalization or collectivization. The campaign was initiated at the end of 1952 and largely completed in 1956. Although a fairly positive policy towards existing industrial and commercial firms were

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[3]. These people included Gao Gang, the first director of the SPC; Li Fuchun, who succeeded Gao; Wang Hefeng; Jia Tofu; Ma Hong; and, above all, Chen Yun, who chaired the powerful Financial and Economic Commission later. See Peter Lee (1987), pp. 43-4.

adopted to ensure the speedy and steady recovery of the economy, some mistakes were also made due primarily to Mao's radical approach towards the pace of the transformation.

In order to push the nationalization and collectivization forward at a faster speed, the leadership took some extraordinary steps. These included violating the principles of "voluntariness" and "mutual-benefit" by resorting to administrative measures or coercive means to force people to accept its arrangements; blindly pursuing high growth rates and large-sized enterprises by excessive merging and regrouping of existing ones; and practising absolute egalitarianism in distribution. Indeed, many of the problems plaguing China's post-Mao economy can be traced to the shift in 1955-6 from a policy of gradual transformation to the one promoting "massive and quick" change.

Furthermore, after the completion of the transformation, the central control, which was imposed on SOEs and joint public-private ventures during the transformation in order to concentrate limited resources to combat capitalists, was not removed or even reduced. Instead, it was *enhanced* and *enlarged* as the public-owned sector was expanding rapidly (Zhu Rongji *et al.*, 1985: 46-7). For example, after the completion of the nationalization in 1956, the number of manufactured products directly under the control of the SPC increased from 115 in 1953 to 380, making up about 60 percent of total industrial output value, while the number of the industrial enterprises directly under the jurisdiction of the central government went up from 2,800 in 1953 to 9,300, accounting for 16 percent of total enterprises and producing 49 percent of total output value (Liu and Wu, 1986: 173-4). At the same time, state-owned trading companies, which had exclusive control over the domestic market, also followed the old track of state monopoly of purchase and marketing of light industrial goods and general merchandise, a method used to restrict capitalists' speculative activities in the process of the transformation.

In fact, as Chen Yun pointed in September 1956, many measures taken during the transformation (including

centralized planning, production, allocation, procurement, and marketing), were not suitable to the development of the national economy in the long-run, and should therefore cease to operate after the completion of the transformation (ibid). However, this call was apparently ignored.

6. *Effects of Implementing the First FYP* The principal task for the first FYP, which officially started in 1953 and ended in 1957, was to carry out the construction of 694 large-scale industrial projects, of which, 156 were Soviet-aided key projects.

As China's financial, physical and technical personnel resources were extremely scarce in relation to the huge demands of these strategic projects, it was neither possible nor sensible to ask local authorities to organize the construction. Thus, in order to strengthen centralized leadership over the implementation of the fist FYP, in 1954 the central government in Beijing abolished the six Greater Administrative Regions, each of which had commanded several provinces, municipalities and autonomous regions, and acted as the highest administrative authority in the region since 1949.[4] Instead, many industrial ministries and economic management organizations were set up in the central government to take over the responsibilities of running the country's economy (Zhu Rongji, 1985: 43).

As a result, a vertical and hierarchical system of ministerial control (*Bumen Guanli*), stretching from Beijing to various localities and enterprises, was established. The central ministries were increasingly able to translate centrally determined policies into effective actions at the microeconomic level. They directly controlled capital construction (in fact, many of ministries had their own construction forces), while local governments focused mainly on developing agriculture, stabilizing prices and caring for people's welfare. In addition, the ministries were also

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[4]. These six regions were the Northeastern, Northern, Northwestern, Eastern, Southwestern, Central and Southern China Regions.

empowered to direct all financial, physical and human resources necessary for the construction. For example, the central government controlled 80 percent of the total fiscal revenues, 75 percent of the expenditures; and more than 1,000 varieties of materials during the period of the first FYP. At the same time, the government also transferred more than 10,000 administrators and a large number of engineering professionals from various places and sectors to the key projects.

As these vertically centralized approaches had proved to be quite effective for capital construction, they were also adopted by other sectors in their economic management later (ibid: 44-5).

2-1-2. Characteristics of the System

The essential elements which distinguish China's Soviet-style economic system from other systems may be highlighted as follows:

1. *Predominance of Public Ownership* The public ownership of producer goods in China generally consists of the State Ownership (*Guojia Suoyouzhi*), or the Whole-People Ownership (*Quanmin Suoyouzhi*), and the Collective Ownership (*Jiti Suoyouzhi*). The former came into being mainly through the outright confiscation and nationalization of the key, large-scale industries and commerce (or the "bureaucratic-capitalist industries and commerce," as classified by the CCP); while the latter was created by the collectivization of agriculture, the small- and medium-sized industrial and commercial businesses, and scattered handcrafts.

The campaign of the Socialist Transformation from 1952 to 1957 was intended to eliminate private ownership and rapidly expand public one. As a result, by 1957 the national economy had been almost completely dominated by the public sector (see Table 2-1.1). There was not much difference between the state and the collective ownership in terms of planning management. In fact, as the pervasive involvement of the government in

almost every aspect of the economy, both of them were virtually controlled and operated by the government.

Table 2-1.1 Composition of the national economy by type of ownership (1950 - 57)

(%)

	1950	1957
Gross value of industrial output:		
The state-owned sector	45.3	68.2
The state-private joint venture	17.8	31.7
Subtotal	63.1	99.9
The private sector	36.9	0.1
Commercial sales:		
Wholesales:		
The state-owned	23.2	71.5
The co-operative	0.6	23.8
The state-private	0.1	4.6
Subtotal	23.9	99.9
The private	76.1	0.1
Retails:		
The state-owned & co-operative	14.9	65.7
The state-private	0.1	31.6
Subtotal	15.0	97.3
The private	85.0	2.7
Handcraft:		
Employment:		
In co-operatives (public)	----	90.2
In individual (private)	----	9.8
Gross value of output:		
Co-operatives	0.8	95.2
Individual	99.2	4.8
Agriculture:		
Households collectivized (public)	10.7	97.5

Sources: Zhou Taihe *et.al.* eds. (1984), pp. 26 & 28-9.

2. *Central Planning System* The reason for the establishment of the public ownership was to develop a Soviet-style central planning system in the Chinese economy. The outstanding feature of this system is the centralization of

economic decision-makings. For example, during the period of the first FYP period, the state drew up plans in 17 fields, namely, agriculture, industry, transportation, post and telecommunications, commerce, foreign trade, education, health services, scientific and technological researches, city public utilities, geological prospecting, capital construction, labour and wages, circulation expenses, material supply, state reserves, and overall financial balance.

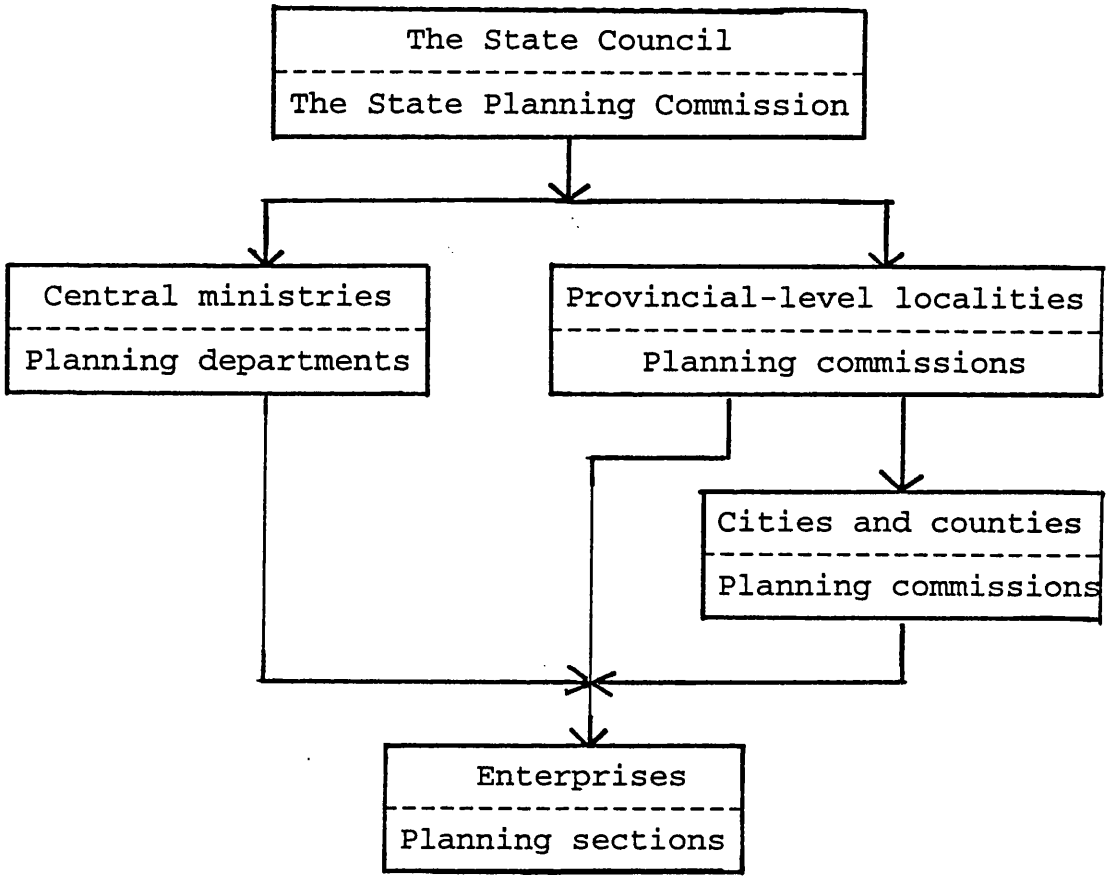
Targets in these plans covered various areas, including the volumes of major industrial and agricultural products, the scope of investment in capital construction, the allocation of important materials, the state financial budget, the number of workers to be recruited and total payroll, purchase and marketing of major commodities, categories and quantities of exports and imports, the issuance of currency, and the prices of major industrial and agricultural products. At micro-level, the central government controlled 9,300 big or key enterprises, whose output value made up 49 percent of the country's total value of industrial outputs.

This highly centralized system made China capable of mobilizing limited physical, human and financial resources to achieve an ambitious and clearly defined goal. Through the central control over resources, the government could generate very high rates of saving and, at the same time, provide a reasonably secure basic level of consumption for all population --- an especially difficult task in a low-income country such as China.

3. *Vertical Command Structure* The centrally planned economy was dominated by a strictly *vertical*, or ministerial, authority line, as opposed to *horizontal*, or territorial, linkages. This can be best indicated by the principle of planning management, i.e. "centralized planning and management at different levels" (*Jizhong Jihua, Fenceng Guangli*). Indeed, as shown in Figure 2-1.1, China's planning system in 1950s was a well-organized, multi-levelled structure, closely integrated with the political structure of the country from the Centre down to enterprises. It clearly depicts a picture of *authority*

orientation, in contrast to the *market* orientation in the Western economy.

Figure 2-1.1 The structure of China's planning organizations in the 1950s



Source: Based on Zhu Rongji *et. al.* eds. (1985), p. 45.

Thus, in production planning, for example, the State Council established overall goals which, in turn, were broken down into specific physical production quotas for each sector or branch of the economy. These, in turn, were dis-aggregated by each central ministry into production targets for specific enterprises under direct ministerial management. Provincial governments nominally carried out a similar planning process for enterprises under local control. Hence, the national economic plan was an aggregation of the plans of each ministry and each provincial-level locality. However, this does not mean that provincial governments were equal to ministries in

the planning process. In fact, their role was severely circumscribed since they only controlled one-fourth of the SOEs, most of which were either small or in low priority sectors.

4. *Application of the Method of Material Balances* In working out the cross-sector or comprehensive plan, the Chinese adopted the Soviet method of Material Balance (*Wuzi Pingheng Fa)*, whereby tables are prepared to indicate how the output of each industry or sector is to be distributed, given existing technology, among all producing industries or sectors, plus final demands.[5] With such tables of inter-sectoral balances, it is then possible to project the pattern of demand for each sector's output that will be generated by a given planned rate and pattern of growth, and to compare it to the supplies likely to be made available by existing capacities and their planned expansions. If balance between anticipated supply and demand is lacking, the plan is adjusted and the possibility of using foreign trade to fill the gaps is explored.

One important consequence of this method is that a disproportionate attention is given to output volume. Indeed, in any system based on physical commodity flows, one has every reason to doubt the adequacy of leaders's attentions toward costs, assortment and quality.

5. *Exclusive Application of Administrative Means* Administrative means, characterized by the mandatory or direct plans, was widely used in the implementation of plans, as opposed to the use of *market mechanisms*. Indeed, administrative means became almost the *only* means for the government to secure the fulfilment of plans. They serve as a responsibility system, in the sense that failure to realize them normally results in disciplinary action against personnel concerned from the superior party or governmental organizations.

Modelled on the Soviet system, the administrative

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[5]. For a brief description of the procedure of constructing a table, see Howe (1978), pp. 53-4.

approach represents the ideal of planner's sovereignty in the process of development. It presupposes that the central planners are able to formulate a rational comprehensive plan, imposing full control over every phase of implementation. In addition, it relies heavily on instruments such as mandatory or direct plans, rules and regulations, experts, and material incentives to enforce policies. For example, during the period of the first FYP, all SOEs and state-private joint enterprises, representing a overwhelming majority of Chinese enterprises at that time (see Table 2-1.1), were placed under direct planning, with mandatory targets issued by the state. This means that their major producer goods were supplied by the competent higher authorities according to plan and their outputs were purchased and allocated for particular use by the commercial or material departments of the authorities.

6. *Principle of Self-Reliance and Fragmentation of the Economy* The development policy in the prereform China rested upon the principle of self-reliance. The central government promoted local self-reliance by decentralizing decision-making authority to local governments, in order to encourage the development of independent local industrial systems.[6] Local authorities, on the other hand, tried to maximize local interests and reduce their dependence on inflows from other regions by engaging in vertical integration and building the systems which could insulate their enterprises from supply shortfalls. This led to the bureaucratic systems moving toward "localism" and "departmentalism."

As a result of this development model, the Chinese economy was so fragmentary that it could be described as a "cellular" economy. The whole industry was compartmentalized by tens of thousands of small-scale, autarkic enterprises, or as Audrey Donnithorne put it, "composed of a myriad of small

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[6]. In fact, the aesthetic of independence and self-reliance in China is one of an inherited peasant outlook that shaped Maoist decision-making. This predisposition was undoubtedly reinforced by the personal experiences of Mao and his associates in the isolated base areas during the war years.

discrete units" (Donnithorne, 1967: 605).[7]

Both the hierarchical and cellular modes have a built-in tendency toward autarky. In the hierarchical system, each ministry strives for self-sufficiency, or departmentalism, which is commonly associated with the Soviet-type economy, in the cellular system, each geographical planning unit tries to be self-contained, or localism, which appears to be a distinctively Chinese phenomenon (Tidrick, 1987).

7. *Politicization of Economic Decision-Makings* In addition to the public ownership and central planning system, what stands out about the Chinese economic system is the ideological and political dominance of economic decision-making (indeed along with virtually all other kinds, as well). In China, the CCP plays a dominant role in formulating, and overseeing the execution of, basic economic policies.[8] The principle is that the CCP provides leadership for the state (the administrative organs of government), and the state manages the economy. Party organizations exercise their leadership by running parallel to entire administrative structure, both centrally and locally.

It is therefore not surprising to find that both party and governmental positions were occupied by the same persons.[9] Because of the mingling of the Party and the government (*Dangzheng Bufen*), and the government administration and the enterprise business (*Zhengqi Bufen*), a public-owned enterprise in China was in fact owned by the government, directly manipulated by the Party. The essence of this politicization is to concentrate the resource allocation power in the hands of the Party, as a power backing to ensure its political

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[7]. For more discussions on the fragmentation of the Chinese economy, see Thomas P. Lyons (1987).

[8]. Howe (1978) provides an excellent analysis of what he refers as "the pervasiveness of political control" in the Chinese economic system, see Howe (1978), chiefly Chapter 2.

[9]. Howe argues that the CCP was more active in the day-to-day administration of economic organization than the Soviet Communist Party. See Howe (1978), p. 32.

control. In practice, this politicization means three things: 1). the prevalence of political criteria in the economic decision-making, that is to say, "ideological values come to be substituted for objective engineering or economic stands of choice" (Riskin, 1987: 84); 2). heavy reliance on political mobilization, in mass scale, through intensive party political propaganda in the implementation of plans; and 3). extensive use of general criteria of choice, often expressed in slogan form (e.g. "walk on two legs," "both redness and expertise," and "go all out, aim high, strive to build socialism faster, better and more economically," etc.).

The consequences of this politicization were: 1). the confusion of the patterns of authority and responsibility in the Chinese economic management system, and 2). more profoundly, making the economic development extremely vulnerable to the power struggles within the Party, which took place from time to time, in other words, planting the seeds of periodical fluctuations and turmoil in the economic development.

2-1-3. Management of Enterprise

The enterprise (*Qiye*) is the basic organisational unit in the Chinese economy. By 1979 the total number of various industrial enterprises had reached 355,013, of which 23.62 percent were state-owned while the rest collective-owned. SOEs, though less than a quarter of the total, generated nearly 82 percent of the total national net output, compared to only 18.14 percent coming from collective-owned enterprises (COEs) (World Bank, 1983, vol. II: 128).

SOEs were generally classified into four types according to their competent authorities: those managed directly by a central ministry; those by both a central ministry and their local authorities with the former assuming the chief responsibility; those by both a central ministry and their local authorities with the latter assuming the chief responsibility; and those by their local authorities only. On

the other hand, COEs, divided into urban- and rural-collective ones, were controlled largely by local authorities (Ma Hong, 1990: 220). This separation of enterprises into vertical systems under central ministries and territorial blocks under local authorities, with weak horizontal links among them, had created the compartmentalization. In other words, the combination of the Soviet-type vertical system with the Chinese regional structure had led to the fragmentation of the economy into pieces controlled separately by vertical (ministerial) and horizontal (regional) lines of command --- the hallmark of China's centrally planned economy.

From the mid-1950s to the late 1970s, there were several changes in the delineation of management authorities in SOEs and urban COEs, placing more power at the hands of enterprises at one time, and re-centralizing the power into central ministries or local governments at another. But by and large, the management system had been centralized throughout the period.

Enterprises, especially SOEs, had to strictly follow the state's unified plans: primary materials needed in production were supplied by the state; products could only be sold to the state procurement or commercial department; profits should be delivered in most, if not all, to the state treasury through their competent bodies; additional fixed assets and working capital had to be appropriated by the state financial department; and workers and staff were assigned only by the state labour bureau, and their welfare and reward funds were drawn according to a fixed percentage of the wage bill and included into the costs of enterprises (Ma Hong, 1990: 121).

Relationship with the State Budget In terms of their financial interaction with the state, the Chinese industrial enterprises were divided into in-budget enterprises (*Yusuan Nei Qiye*) and extra-budget enterprises (*Yusuan Wai Qiye*). The number of the first group reached about 40,000 in 1979-80, accounting for 47.71 percent of SOEs. Their profits (or losses) and tax payments (industrial and commercial tax) were

included in government budget revenues under "enterprise incomes." The second group, including over half of total SOEs, remitted their profits either to extra-budgetary funds of local governments or to accounts of ministerial systems, bypassing the budget.

By definition, all COEs belong to the second group since their financial interaction with the state took the form of tax payments rather than profit remittance. They paid a graduated profit tax, which amounted to 55 percent of their profits after indirect taxes, such as industrial and commercial tax. The remainder of the profits was divided on a basis of the formula that varied in detail according to the trade of enterprise and the locality.

Enterprises were also required to hand over their Basic Depreciation Funds for Fixed Assets to the state treasury. The funds was drawn according to the pre-set depreciation rate on all fixed assets in use except the land, on the basis of the original value of the assets and the service period. Enterprises must submit their applications for any addition to plant, equipment, and even improvement for existing equipment. After the approval of the higher authorities, the treasury would allocate special funds to them.

Norms for Examination There were a few changes in the number of the norms whereby the government assessed the performance of enterprises. But generally speaking, the following twelve norms were to be essential: total output value, output of major products, trial-production of new products, major economic and technological quotas, use of capital, cost reduction rate, total amount of costs reduced, number of workers and staff at the end of year, total payroll, average wages, labour productivity, and profits (Liu and Wu, 1986: 174). All these targets were obligatory for SOEs, but few were able to achieve all of them.

2-2. The Foreign Trade System

Having established the command industrial planning and management system, the CCP moved swiftly to set up its own foreign trade system, which was also modelled after the Soviet practices. By 1956, the government had either taken over or nationalized all key foreign trade corporations left over by the previous regime. The state trading system had remained basically unchanged until the late 1970s.

The fundamental policy for China's foreign trade was to strengthening national "independence and self-reliance" (Liu Chaochin, 1978: 3-6). In pursuing the policy, the government believed that foreign trade and other international transactions should follow the principle of "equality, mutual benefits and supplying each other's needs" (ibid: 6-12).[10]

Accordingly, the objective of foreign trade was to import only goods necessary to compensate for unexpected domestic production shortfalls and goods that could not be produced domestically in sufficient quantities, if at all. On the other hand, exports were promoted mainly to generate foreign exchange to pay for imports (World Bank, 1983, vol. I: 139). Clearly, this objective was designed to reduce the dependence of the Chinese economy on imports, with a view to developing domestic industries whose output would eventually substitute for imports. Such trade regime definitely represents the strategy of import substitution.[11]

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[10]. This attitude stemmed from the perception that trade had been used by the imperial powers before 1949 to gain political dominance in China, and reinforced by the bitter experiences of the Western embargo against China, the new communist regime's international isolation, and the sudden withdraw of Soviet aid in the 1950-60s.

[11]. N. R. Lardy argues for this view and sees the Chinese prereform trade regime as "an extreme example of import substitution". See Lardy (1992a), Chapter 2.

2-2-1. The Role of Foreign Trade

As a result of the above policy, principle and objective, plus the large size of the country, the diversified resource endowments, and the inward-looking tradition of the people, the role played by China's foreign trade in the national economy was therefore very limited. Table 2-2.1 shows that China's trade to GNP ratio in 1978 remained one of the lowest in the world, even with the rapid growth of trade in the 1970s. The shares of exports and imports in China's GNP were only 4.5 percent and 4.7 percent, in sharp contrast with 11.1 percent and 12.4 percent, respectively, for all low-income developing countries. Even comparing with other big developing countries such as india, Indonesia and Brazil, China's shares are still markedly lower than theirs.

Table 2-2.1 Shares of exports and imports in GNP for several selected countries (average for 1977-78)

(%)

Country	Exports/GNP	Imports/GNP
China	4.5	4.7
India	6.1	6.9
Indonesia	26.2	15.1
Bangladesh	7.1	17.0
Turkey	4.0	10.3
Brazil	7.3	8.2
Mexico	6.0	8.0
Japan	11.2	10.0
U.S.A.	6.5	8.5
U.S.S.R.	5.6	5.2
Low-income Developing Countries (1978)	11.1	12.4
Middle-income Developing Countries (1978)	16.5	21.2
All Developed Countries(1978)	15.5	16.0

Source: The World Bank (1983), vol. I, p. 140.

However, in the long run foreign trade had played a significant role in China's economic growth (Eckstein, 1966;

Hsiao, 1977). Through trade China obtained much needed raw materials and technologically advanced machinery and equipment to expand its production capacity.[12] In the short run, trade served as a channel to transfer resources from agriculture to industry and from consumption to investment. In other words, through trade agricultural goods, minerals, and industrial products were exported in exchange for the imports of those industrial machinery, equipment, raw materials which were unavailable at home.

2-2-2. The Planning of Foreign Trade

The state monopoly of foreign trade in the prereform China was achieved through a highly centralized organisational framework. The Ministry of Foreign Trade (MOFT) was the executive body responsible for planning, supervising and conducting foreign trade. In conjunction with the SPC, it drew up the annual and long-term foreign trade plans and drafted laws and regulations concerning foreign trade. Only the MOFT and its overseas missions were authorized to hold economic and trade talks, and to sign agreements and protocols, with foreign countries. The state's foreign trade plans were implemented by a number of foreign trade corporations (FTCs) that specialized in trade in defined product groups.[13]

There was a Foreign Trade Bureau (FTB) in each province, autonomous region, and municipality. They were vertically under the MOFT but also received guidance, supervision and assistance from the regional government, with the former assuming the chief responsibility. In parallel, the FTCs also had their branches in most province-level regions and offices

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[12]. China-USSR trade was very unusual in this sense --- trade was more than exchange of goods.

[13]. These FTCs included China National Cereals, Oils and Foodstuffs; Native Produce and Animal By-Products; Textiles; Light Industrial Products; Arts and Crafts; Chemicals; Machinery; Complete Plant; Technical; Medicine; and Metals and Minerals Import and Export Corporations; plus China National Export Commodities Packaging Corporations.

in some major ports. Similarly, these branches and offices were under "dual leadership" of their respective FTCs in Beijing and the FTBs in the regions and ports concerned.

The planning of foreign trade was an integral and essential part of China's central planning system. Foreign trade plans included the plans for the flow of goods, transportation, accounting, foreign exchange, capital construction, labour and wages, etc. Of them, the plan for the flow of goods was the most important one. It covered procurement, export and import, the appropriation of export goods, and the acquisition and use of foreign exchange, etc (Liu Chaochin, 1978: 13).

The plans were worked out through the method of Material Balance. In June-July of the preceding year, all central ministries, FTCs and FTBs in the provinces, autonomous regions and municipalities were requested, in the light of the directives of the SPC and the MOFT, to estimate goods available for export and their import requirements for the coming year. Then preliminary discussions were held between the regional FTBs and the SPCs to coordinate and balance all supplies and demands within the local economy. The balanced regional plans, together with those of central ministries, were submitted to the head office of the FTCs in Beijing. The MOFT and the central SPC did the final and overall balancing through convening a national foreign trade planning conference in September-October. The purpose of the conference was to try to meet import requirements of one locality by the proposed exports from another in order to determine the national net import requirements and exports. The revised foreign trade plan was then submitted to the State Council by the end of the year for ratification.

Thus, China's foreign trade planning was firmly embodied in its central planning system. Because of this, the level of foreign trade tended to fluctuate closely with the level of domestic economic development. As shown in Table 2-3.1, when national output grew rapidly, as during the periods of 1957-59, 1962-66 and 1976-78, the scale of investment increased,

raising the demand for imports. Conversely, when the economy declined, as during the periods of 1960-62 and 1966-68, the scale of investment decreased, lowering the demand for imports. As the import demand increased or decreased, exports also increased or decreased in response to the increase or decrease in the demand for foreign exchange.[14]

2-2-3. The Pricing in Foreign Trade

It is clear from the above description that prices had little chance to serve the functions of allocation and stimulation, if at all, under the foreign trade planning system. In fact, the State Price Bureau under the State Council fixed prices for both domestic and foreign goods. All trading agencies had to follow the prices set by the state. The fundamental objective of the price fixing was to insulate China from the influence of price fluctuations in the world market. In doing so, the Chinese authorities hoped to maintain domestic prices stable and to protect domestic industries (World Bank, 1983, vol. II: 445).

Of course, the selling prices of exports and purchasing prices of imports were determined by the world market conditions. The price fixing was applied mainly to the determination of domestic procurement prices of export goods and the domestic selling price of imported goods.

In general, trading agencies purchased export goods pre-specified by the state plan from domestic producers at either ex-factory prices in the case of manufactured goods or procurement prices in the case of agricultural goods. That is to say, producers were paid the same price for a goods they produced regardless of its destination, be the domestic market or the overseas market. Furthermore, they received none of foreign exchange income from the sale of their goods abroad, nor did they have any right to use that foreign exchange to import goods for their own use. As a result, they had little

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[14]. Hsu (1989) has elaborated discussions on this causal link. See chiefly Chapter 1.

incentive to export or to increase exports.

On the other hand, the domestic prices of imported goods were generally made comparable to similar, domestically produced goods. This means that imported goods were sold at either ex-factory prices, in the case of manufactured goods, or national supply prices, in the case of agricultural goods, of similar domestic goods. If uniform ex-factory prices or national supply prices did not exist, the announced wholesale prices of similar domestic goods in the country's major trading ports were applied.

However, about 20 percent of the prices of imported goods could not be determined in this way because the imported goods were either not produced domestically or were produced infrequently. In these cases, prices were fixed by converting the import price (C.I.F.) valued in foreign exchange to Renminbi at the prevailing official exchange rate. As the official exchange rate was significantly overvalued, the conversion caused the domestic prices of imported goods to be substantially lower than they would have been at an equilibrium exchange rate. This means that the end users of the imported goods actually received implicit subsidies from the state.

This pricing policy, coupled with the official exchange rate, had created a distorted picture of profits and losses in foreign trade. As we know, in order to maintain a low and stable living costs on the one hand and raise sufficient revenue to finance industrialization programmes on the other, the Chinese authorities pursued a differential pricing policy --- keeping the prices of primary goods, especially daily necessities low vis-a-vis those of manufactured goods.[15] This resulted in the situation, as illustrated in Figure 2-2.1, in which the prices of primary goods in China were generally lower while the prices of manufactured goods higher than those

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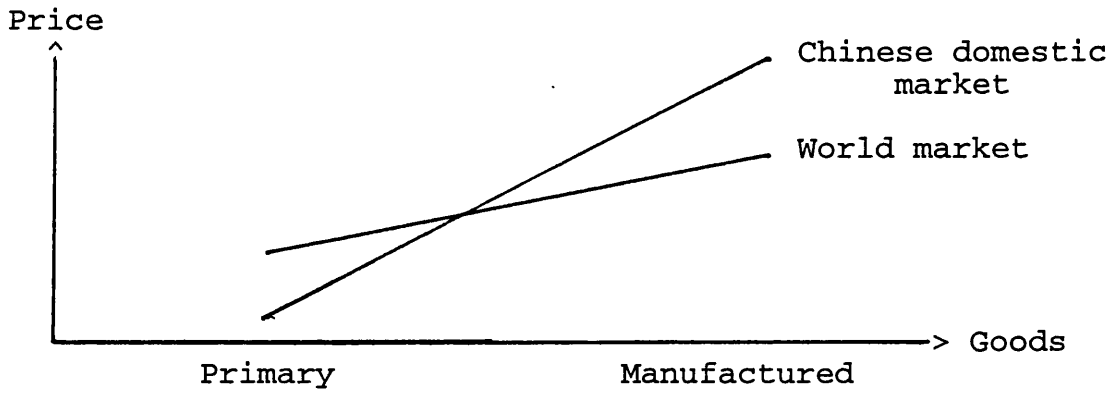
[15]. This policy is known in China as the policy of "scissors differentials" (*Jiandao Cha*).

in the world market.[16]

Figure 2-2.1 The price differential between the domestic and world markets in the prereform China



Under this circumstance, the trading companies in China generally made accounting profits on exports of primary goods and on imports (after tariffs) of manufactured goods, but losses on exports of manufactured goods and on imports (even before tariffs) of primary goods. The profits and losses were then evened out within the entire state trade system, which tried to use profitable trade to finance the loss-making or unprofitable trade in order to earn badly needed foreign exchange.[17]

In short, the planning and pricing systems of foreign trade, together with the overvalued exchange rate, had enabled China to avoid balance of payments deficit, to isolate the domestic market from the instability of the world market, and to control the level and composition of exports and imports. As a result, from the mid-1950s to the late 1970s China had been able to have an almost inflation-free economy and its

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[16]. For example, in 1980 a ton of imported wheat costs about ¥390 at the official exchange rate, compared with only ¥300 of its domestic selling price. On the other hand, the cost of an imported 12" black and white TV set was merely ¥300, in contrast with ¥500 of its domestic price. See the World Bank (1983), Vol. II, pp. 447-8.

[17]. For a more elaborated analysis of the differential pricing policy and its consequences in the Xiamen SEZ, see Chapter 7.

inefficient industries had been well protected.

2-3. The Causes of the Present Reform and Openness

The prereform Chinese economy had on the whole made fairly impressive achievements, especially in terms of gross growth figures. As can be seen from Table 2-3.1, except the sharp fall in the second FYP period due to the Great-Leap-Forward campaign, natural disasters and the sudden withdrawal of Soviet economic assistance, China's national income, gross value of industrial output (GVIO), exports and imports had managed to grow at remarkably high speeds in most of the other

Table 2-3.1 China's national income, gross value of industrial output, exports and imports (1952-1978)

	National income	GVIO	Exports	Imports
	(¥100 m. in 1952 prices)		U.S. $100 million	
1952	589	349	8.23	11.18
1953	671	455	10.22	13.46
1954	710	529	11.46	12.87
1955	756	559	14.12	17.33
1956	862	715	16.45	15.63
1957	901	798	15.97	15.06
1958	1,100	1,235	19.81	18.90
1959	1,190	1,681	22.61	21.20
1960	1,173	1,870	18.56	19.53
1961	825	1,154	14.91	14.45
1962	771	963	14.90	11.73
1963	853	1,045	16.49	12.66
1964	994	1,250	19.16	15.47
1965	1,163	1,580	22.28	20.17
1966	1,361	1,910	23.66	22.48
1967	1,262	1,647	21.35	20.20
1968	1,180	1,565	21.03	19.45
1969	1,408	2,101	22.04	18.25
1970	1,735	2,785	22.60	23.26
1971	1,857	3,194	26.36	22.05
1972	1,910	3,414	34.43	28.58
1973	2,069	3,739	58.19	51.57
1974	2,092	3,761	69.49	76.19
1975	2,266	4,344	72.64	74.87
1976	2,206	4,449	68.55	65.78
1977	2,378	5,099	75.90	72.14
1978	2,671	5,790	97.45	108.93

cont'd...

Annual average rates of growth (%)[18]

1st FYP period (1953-1957)	7.65	15.08	11.81	2.85
2nd FYP period (1958-1962)	-8.50	-6.03	-6.87	-11.24
Readjustment (1963-1965)	16.77	22.96	16.24	26.22
3rd FYP period (1966-1970)	6.26	9.89	-1.14	0.86
4th FYP period (1971-1975)	5.10	7.99	28.84	35.75
1976 -- 1978	10.04	14.08	19.23	26.68
1952 -- 1978	**5.99**	**11.41**	**9.97**	**9.15**

Sources: 1). National income and GVIO: SSB (1991), pp. 32-3; 54-5;
2). Exports and imports: The ACFERT Editorial Board (1991), p. 317.

periods, with the average annual growth rates for the prereform period (1952-78) standing respectably at 5.99 percent, 11.41 percent, 9.97 percent, and 9.15 percent, respectively.

What accounted for the industrial growth? Table 2-3.2 breaks GVIO into two factors: inputs (workers and capital) and input productivity (output per worker and per 100 Yuan of capital) and shows the underlying reason for the growth from 1952 to 1978. It reveals that the industrial development had

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[18]. The annual average rates of growth in percentage terms given in this thesis are uniformly calculated by the use of the compound interest formula:

$$r = \left(\sqrt[n]{\frac{P_n}{P_0}} - 1 \right) 100$$

where r = the required annual average rate of growth over n time periods;
P_0 = the first value of the original data;
P_n = the nth value of the original data.

This formula, though different from that used by the Chinese authorities, is used by the official publications of many international organisations, such as the UN and IMF. For more explanation of this formula, see, e.g. Bowers (1982), pp. 66-7.

been sustained largely through the injection of inputs, reflecting the Maoist strategy of "extensive" (as opposed to "intensive") growth. Although labour productivity increased by 4.01 percent per annum, it was heavily outstripped by the growth of workforces (7.11 percent per annum). What is more, the injection of capital increased even faster than the growth of industrial output (12.58 percent vs. 11.41 percent per annum), and this of course resulted in the decline in output-capital ratio (*negative* 1.13 percent per annum).[19]

Table 2-3.2 Growth rates of output per worker and per 100 yuan of capital in Chinese industrial enterprises (1952 - 1978)

(1952 = 100)

	(1) GVIO	(2) No. of workers (year end)	(3) Fixed & working capital	(4) Output per worker [(1)/(2)]	(5) Output per ¥100 of capital [(1)/(3)]
1952	100.00	100.00	100.00	100.00	100.00
1957	228.65	146.67	227.93	155.90	101.62
1965	452.72	242.75	708.45	186.51	64.07
1978	1659.03	596.27	2175.34	278.24	74.41
Average annual growth rates (%)					
52-57	17.99	7.96	17.91	9.29	0.32
57-65	8.91	6.50	15.23	2.27	-5.60
65-78	10.51	7.16	9.01	3.12	1.16
52-78	**11.41**	**7.11**	**12.58**	**4.01**	**-1.13**

Sources: 1). GVIO: Table 2-3.1;
2). Workers & capital: SSB (1985a), pp. 71 & 84.

Table 2-3.3 presents a rough estimate of the change in output per unit of combined inputs, i.e. total factor

[19]. The decline in the output-capital ratio was in fact larger than shown here if capital had been valued in fixed prices (like GVIO), the index would have grown still faster and output per 100 Yuan of capital fallen father.

productivity (TFP).[20] It demonstrates that, however the separate factors are weighted in aggregating them, the aggregate factor grows much faster than the TFP. When labour is given a greater weight of 0.6, the growth of TFP is higher, 1.16 percent per annum for the period of 1952-78 and 0.27 percent per annum for 1957-78. But when labour is given a smaller weight of 0.4, the former rate drops to 0.28 percent while the later is even *negative* 0.40 percent.

Table 2-3.3 Growth rates of industrial output, total factor input and total factor productivity (1952 - 1978)

(1952 = 100)

	Total factor input index assuming labour share of:			Index of output per unit of combined inputs at assumed labour share of:	
	0.6	0.4	GVIO index	0.6	0.4
1952	100.00	100.00	100.00	100.00	100.00
1957	179.17	195.43	228.65	127.62	117.00
1965	429.03	522.17	452.72	105.52	86.70
1978	1227.90	1543.71	1659.03	135.11	107.47
Average annual growth rates (%)					
1952-78				**1.16**	**0.28**
1957-78				0.27	-0.40

Source: Table 2-3.2.

Although the above estimates are derived from crude data, it seems safe to conclude that most of the industrial growth had come from the increases in production factors, particularly fixed capital, supported by high levels of savings, and that very little of it was due to more efficient

[20]. For the explanation of this methodology, refer to Dwight H Perkins (1988), pp. 628-9. Many other similar studies, such as Rawski (1986), Dernberger (1988), and Chen Kuan, *et al.* (1988), apply more or less the same method. Woo, *et al.* (1993), however, argues that this method tends to "overstate" the growth of TFP due to the "incorrect treatment of intermediate inputs."

use of inputs. This indicates that productivity gains from new technology, improved education, and the accumulation of industrial experiences had been totally offset by the cost increases arising from other causes.

On the other hand, despite the fact that China's exports and imports had enjoyed more than 9 percent of average annual growth rate between 1952 and 1978, their shares in GNP were, as shown in Table 2-2.1, still among the lowest in the world in 1977-78. Furthermore, China's share and ranking in world total exports had fallen substantially. Table 2-3.4 reveals that, after surging to 1.95 percent and the twelfth place in 1959, China's share and ranking slipped back steadily, dropping to only 0.75 percent and the thirty-second place in 1978.

Table 2-3.4 China's share and ranking in world's total exports (1952-78)

	World's total exports	China's exports	China's share	Ranking
	(U.S. $100 million)		(%)	
1952	809	8.23	1.02	20
1957	1,123	15.97	1.42	15
1959	1,159	22.61	1.95	12
1965	1,872	22.28	1.19	18
1970	3,153	22.60	0.72	29
1976	9,933	68.55	0.69	34
1977	11,269	75.90	0.67	30
1978	12,988	97.45	0.75	32

Sources: 1). 1952: The ACFERT Editorial Board (1987), p. 396;
2). 1957-78: The ACFERT Editorial Board (1991), p. 322.

The flagging performance in the economy had also affected the improvement of people's lives. Indeed, from 1952 to 1978 the living standards in China had almost stagnated and in some areas fallen. Whereas the national income grew by nearly 6 percent per annum during that period, the national income per capita only managed to rise by 3.87 percent per annum (from ¥104 in 1952 to ¥279 in 1978) (SSB, 1985b: 7). Not

surprisingly, the index (1952=100) of real wage for the state-owned sector dropped markedly from 130.3 in 1957 to 115.2 in 1978. While the per capita consumption of meat increased modestly from 7.27 kg per year in 1952 to 8.86 kg in 1978 and eggs from 1.02 kg to 1.97 kg, basic food grain fell from 198 kg to 195 kg, and cooking oils from 2.1 kg to 1.6 kg. At the same time, the ratio of city dwellers's consumption level to peasants' increased from 2.39:1 in 1952 to 2.90:1 in 1978, suggesting the widening of the gap of living standard between cities and rural areas (Social Statistics Sector, 1990: 75; 82 & 84).

To sum up, in the first three decades (1949-78) of the PRC as a centrally planned economy, only in the first FYP period (1953-57) did the Chinese succeed in fulfilling the Plan. In the other periods, the planning processes were consistently interrupted by recurrent political upheavals and consequent economic fluctuations. Although most quantitative indicators were generally on the up-trend, some important qualitative targets, such as productivity and living standards, stagnated or even deteriorated.

At the macro level, the fragmentation of the economy and the lack of horizontal links among various regions and economic entities resulted in massive inefficiencies and wastes in resource allocation. The dominance of small-sized enterprises in the industry entailed the failure to exploit the economies of large-scale production.

The foreign trade planning and pricing systems, by insulating the domestic market from the world market, had seriously dampened the initiative and creativeness of regions and enterprises to increase their exports and improve product quality. They had also reduced the effectiveness of technology transfer and the competitive pressure from abroad, thus depriving China of benefitting from the dynamism of the world economy.

At the micro level, the paternalistic role played by the state toward the enterprise had discouraged the latter to

innovate to raise productivity. It also led to the problem known as "soft budget constraints" (Kornai, 1980). Other phenomena, such as the "expansion drive," "investment hunger," and "bonus abuse," were all associated with the fundamental defect.

In the final analysis, there existed both allocative inefficiency and X inefficiency on a grand scale in the prereform Chinese economy (Perkins, 1988: 602). No wonder the Chinese authorities described the state of the Chinese economy in 1976-77 as "at the brink of collapse." It was therefore imperative for the post-Mao leadership to make a fundamental change to China's Soviet-type, centrally planned economic system.

CHAPTER 3

THE CHINESE INDUSTRIAL AND FOREIGN TRADE REFORMS

The Third Plenum of the Eleventh Congress of the Central Committee of the CCP, held in December 1978, is widely regarded as a "turning point" in China's contemporary economic development. At the Plenum, the post-Mao leadership announced that the focus of the Party's work would shift from the ideological emphasis on "class struggle," that had plunged China into turmoil in the previous decade, to the goal of "socialist modernization." At the same time, it was decided that a programme of "readjustment and reform" should be carried out in order to "resolve the serious imbalances in the national economy" (Ma Hong, 1990: 27). Since then China has embarked on the course of what is now known as the "second revolution" --- reform and "open-door" (*Gaige he Kaifang*).

In general, the reform is intended, at the macro level, to replace direct control with indirect control through introducing market mechanisms and, at the micro level, to increase enterprise autonomy. The "open-door" policy is designed to open China to the outside world. It includes three major components: expansion of foreign trade; utilization of foreign capital; and development of the SEZs and other open areas. Both the reform and "open-door" policy have been implemented in an incremental manner but already have had profound effects on both the structure and performance of the Chinese economy.

The purpose of this chapter is to examine the reform that took place in the industrial and foreign trade sectors. The other two important components of the "open-door" policy --- the utilization of foreign capital and the development of the

SEZs --- will be discussed in the next chapter. Clearly, it is very difficult, if not impossible, to cover every area of the reform and openness in a limited space. So all subjects chosen to be examined in this and the next chapters are pertinent to, and thereby intended to provide a necessary contextual background for, the further discussions of the reform and development in the Xiamen SEZ in subsequent chapters.

3-1. The Industrial Reform[1]

According to Liu Guoguang, a leading Chinese economist, the industrial reform, or urban reform (as opposed to the rural reform), can be divided into two phases. In the first phase, from 1979 to 1984, the reform, focused mainly on increasing local and enterprise autonomy, was implemented in some pilot cities and enterprises. The adoption of the historic decision concerning the reform of China's Soviet-style economic structure (hereafter the Reform Decision) by the CCP in October 1984 marked the beginning of the second phase (see Appendix A),[2] in which the reform has been centred by the invigoration of enterprises and carried out in full scale and all over the country (Liu, 1987c).

The Essence of the Reform

As described in the preceding chapter, the fundamental weakness of China's Soviet-type industrial system has been low efficiency of resource use, difficulty in administrative coordination and a bias against innovation. As a result, the

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[1]. For a detailed and all-round discussion of the Chinese industrial reform, see, for example, the World Bank (1983), (1985) and (1990); JEC (1986) and (1992); Tidrick and Chen (1987); Riskin (1987); Liu Guoguang (1987b); Ma Hong (1990); Nolan and Dong (1990); and Singh (1992).

[2]. Thomas G. Rawski argues that it is an unique document in the history of the economic reforms in socialist countries as nothing similar had happened in the former Soviet Union and eastern European countries. See Rawski (1986).

TFP stagnated and, in some years, even declined. Thus, how to eliminate those crucial problems, raise the TFP, and, ultimately, people's living standards should be the main objective of the Chinese industrial reform.

In terms of the reform strategy, however, the Chinese authorities saw the "invigoration of enterprises, particularly the large- and medium-sized enterprises owned by the whole people" as the top priority of the reform. At the same time, they also identified price reform as "the key to the success of the overall economic reform" (Central Committee, 1984). By and large, the industrial reform includes two essential aspects: policy changes and organisational changes. The important reform policies and changes can be featured in the following sections.

3-1-1. The Planning Reform

Central planning is at the core of the socialist economic management system, controlling and influencing other aspects of the system. The planning system reform thus plays a vital role in the overall economic reform.[3] The central planning system can be divided into macro- and micro-planning systems. The former includes national plans, ministerial plans and regional plans, while the latter is primarily associated with an enterprise's allocation of its human, physical and financial resources.

Having discarded the traditional idea that a socialist economy would *ipso facto* entail a planned economy, and that the confrontation between socialism and capitalism is equated with planning economy versus market economy, the new pragmatic leadership was anxious to introduce some market mechanisms to mitigate its seriously distorted economy.[4] Two important

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[3]. For a general discussion of the reform in the Chinese planning system, see Tidrick (1987), Chen Jiyuan (1987) and Naughton (1986).

[4]. For more about the fundamental change in the Chinese economic theory, see Liu Guoguang (1987d).

developments have taken place:

First, from 1984 to 1989, the number of products controlled by the mandatory plan had been cut down from 126 to 60 and their share in the total industrial output value had dwindled from 40 to 20 percent (Liu Guoguang, 1989). The proportion of mandatory planning in the economy in some relatively more developed provinces, such Guangdong, Jiangsu and Zhejiang, had reduced to 5-10 percent (Ma Hong, 1991).

At the same time, the Chinese has increased the range of guidance planning, whereby various economic levers, such as price, tax, interest rate, exchange rate, wage and government subsidy, are applied. Many more economic activities, particularly those in light industry, commercial and service sectors, have simply been left to market regulation.[5] In 1988, for instance, the shares of the industrial output value subject to the guidance plan and to market regulation reached 42.9 percent and 40.9 percent, respectively (ibid).

Second, as a result of increasing use of the guidance plan and market regulation, the planning contract responsibility system has gradually replaced the mandatory plan. For example, some planning departments have begun to choose competent enterprises to implement plans through public bidding, and this is particularly true in the case of capital construction. By the late 1988, 44 percent of the national large- and medium-scale construction projects, numbering 11,000, had been contracted out. At the same time, several central ministries, such as those of Petroleum, Coal, Metallurgy, and Railway, have also started to implement a variety of planning contracts.

On the other hand, to support the increasingly important role of central city, the economic development plans for ten cities, including Wuhan, Shenyang, Dalian, Guangzhou, Xi'an and Xiamen, had been contracted out during the period of 1983-88. In addition, these pilot cities had also been granted

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[5]. For the definition and range of mandatory planning, guidance planning and market regulation, see Naughton (1986), pp. 619-20.

provincial-level planning powers (Gao Shangquan, 1989: II-40), with a view to speeding up the dismantlement of the compartmentalization by ministries and localities and integrate all economic activities along economic lines.

Planning in the form of contract, seen by the Chinese reformers, provides restraints against the direct interference from governmental departments, since contracts are based on the recognition of each's economic interests and responsibility and therefore can only be implemented through legal procedures. It is also conducive to bring up contracted units' self-motivating and self-restricting mechanisms so as to make the units behave rationally. Thus, the system creates a possibility for the state to incorporate those important economic activities into its plan through contracts, and develops a better combination of market regulation with an appropriately modified planning system.

3-1-2. The Price Reform

As introduced above, the implementation of the mandatory plan is chiefly relied on two other compulsory plans: material supply plan and financial plan, whereas the guidance plan is basically realized through economic levers, prices in particular. As price reform will inevitably cause redistribution of economic interests among various social groups and between producers and consumers, and hence affect every aspect of the national economy, it is the most difficult and risky reform in a command economy.[6]

Nevertheless, the Chinese price reform has resulted in some tangible changes. In addition to the adjustment in the prices of some major agricultural goods, raw materials and energy in line with their relative scarcity, a few steps have also been taken to restructure the over-centralized price

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[6]. For a general discussion of China's price reform, refer to Xue Muqiao (1985); the World Bank (1985); Barry Naughton (1986); Wang Jiye and Zhu Yuanzhen (1987); and Zhu Ming (1989).

control system in parallel with the changes in the planning system. First, the single state-fixed-price system has been replaced by a multiple-price one, with the fixed price, floating price and free price coexisting.

Second, the scope of the fixed price has been substantially reduced, while the range of the floating price and the free price enlarged.[7] Consequently, some producer goods, whose prices were traditionally controlled by the state, are now allowed to be sold by enterprises, if they fulfil the state plan, at the price not exceeding the ceiling one set by the state.

And third, price control over small commodities had been lifted by October 1986 (Wang and Zhu, 1987: 837). As a result, the ratio of the products and services subject to the fixed price to those subject to the floating and free prices dropped to 50:50 in 1985, and further changed to 25:75 in 1990 (Ma Hong, 1991).

This decontrol of prices, by giving market demand and supply a greater role in price determination, has contributed to correct accumulated distortions. The multiple-price system for producer goods, has enhanced the flexibility of supply through providing incentive to expand production of goods in short supply and leading scarce resources to users with great need, as reflected by ability to pay.[8] For example, Shijiazhuang, the capital city of Hebei province, failed to import any extra-plan materials from the other parts of China

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[7]. Barry Naughton argues that the most important component of China's price reform is the toleration of a market fringe in which prices are governed to a large extent by market forces. If planners are successful in implementing their intention that aims at expanding the marketized sector of the economy, this change will automatically imply significant price reform. See Naughton (1986).

[8]. There are several prices for key producer goods (in ascending order): the centrally controlled allocation price; the floating price for self-marketed output; the locally controlled allocation price; and the negotiated price in the markets of varying legality. Tidrick, on the other hand, argues that the multiple-price system is run at a high cost, though it did improve supplies. See Tidrick (1987).

in early 1984 because of implementing the old single state-fixed-price system. Since the multiple-price policy was introduced in August of the same year, the situation changed completely. By the end of the year, 50,000 tones of steel, 41,000 cubic metres of timber, 774 vehicles and 70,000 tones of cement had been imported (Wang and Zhu, 1987: 954).

Obviously, the easier access to extra-plan materials has enabled enterprises that could not obtain, or could not obtain enough materials from the planned channel for varied reasons to get critical inputs. Thus, the multiple-price system has to some extent weaken the central control over resource allocation and, as a result, enhanced enterprise ability to organize economic activities by responding to needs in the market.

3-1-3. The Material Supply System Reform

In correspondence with the planning and price reforms, some important changes have also taken place in the material supply system.[9] First, the number of goods subject to the planned allocation was reduced from 256 in 1979 to 27 in 1989 (Liu Guoguang, 1989). Even those 26 goods are not *all* allocated through the plan. For instance, only 50 percent of the total output of steel, 40 percent of coal, 25 percent of timber, and 15 percent of cement are subject to the planned allocation. At the same time, the number of enterprises acquiring inputs through the state supply has been decreased as well. In Shenyang alone. for instance, the number dropped from 30,000 in 1984 to 12,000 in 1987 (Wang and Zhu, 1987: 854).

Second, the single channel of centrally planned allocation has been diversified. As many enterprises are allowed to sell some above-quota products, an elementary and scattered market network of input factors has emerged. There

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[9]. For a general discussion of the reform of China's material supply system, refer to Byrd and Tidrick (1987); Gene Tidrick (1987), Tang Zhongkun (1987); and Liu Suinian (1991).

have been some 500 material trade centres now in big cities, such as Shanghai, Wuhan and Haerbin etc., apart from 900 county-level ones. The centres in Shanghai, for instance, have imported various goods valued at ¥1.1 billion for more than 30,000 enterprises since they were set up in 1979. In 1990, the aggregate turnover for all sorts of material trade centres in the country reached ¥41.9 billion, up by nearly 19 percent over 1989 (Liu Suinian, 1991: II-47).

Third, instead of through central supply system, many centrally controlled enterprises and key construction projects acquire their inputs increasingly from local cities, where the enterprises or projects are located. This new material flow route, while largely shortening transport distance, reducing inventory and thus speeding up good turnover, has given a greater role to cities in organizing local economic activities. Shanghai, Chongqin, Changzhou and Shashi took a lead in setting up such new input supply model. As a result, trading and cooperations among cities and regions have rapidly expanded. In Jiangsu province alone, for example, three material cooperation zones, Suzhou-Wuxi-Changzhou, Ningpo-Zhenjian-Yangzhou, and Nantong-Huaibei-Yancheng, have emerged. According to Mr. Liu Suinian, the minister for the Ministry of Material Supply, the total value of the materials organized through such regional cooperation in the country in 1990 amounted to ¥90 billion, up by 16.3 percent over 1989 (ibid).

Thus, it becomes clear that China's material supply system is shifting from a mode of single channel with many links to one of multiple channels with few links, This change has increased the flexibility of material supply and reduced enterprise's dependence on the centrally planned allocation, thus providing a possibility for enterprises to freely enter into or withdraw from an economic activity.

3-1-4. The Relationship between the Centre and the Locality

According to the Reform Decision, the industrial reform

is in fact to restructure three important relationships: the one between the Centre and the locality; the one between the state and the enterprise; and the one between the enterprise and its workers and staff. Because of the country's large size, a problem in China's economic system that has been more difficult to resolve than in any other centrally planned economy is the relationship between the Centre and the locality.

The relationship actually contains two issues: the financial relationship between the central government and the local government and the planning relationship between the central ministry and the local region, or between *Tiaotiao* (sectoral "lines") and *Kuaikuai* (regional "blocks"). The latter has proved to be more difficult to tackle than the former (Liu Guoguang, 1984).

First, the post-Mao leadership has taken a series of steps to reform the financial relationship, especially the way of apportioning revenues and expenditures, between the central government and the local government so that responsibility in particular sphere can be firmly attached to one level or another.[10] Under the principle that the central government should control most of financial (including foreign exchange) resources while the local government may own the rest. Three major changes have taken place: 1). each province-level locality (including those independent planning cities), instead of the central government alone, has to be responsible for the balance of its own budget once the particular arrange is made with the central government.

2). the ratios of apportionment of revenues and expenditures will not change within five years, instead of one year, once they are fixed.

3). six differentiated budgetary policies, instead of one uniform policy, are applied to different localities according to their financial situation. For example, affluent Guangdong

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[10]. For more about China's current financial reform, see Audrey Donnithorne (1981); Wang and Zhu (1987), pp. 844-7; and the Reform Department of the Ministry of Finance (1989).

province has to deliver a fixed amount of its profit and tax revenues (¥1.5 billion) annually to the central government, while relatively poor Fujian province receives a fixed amount of subsidy (¥100 million) per year (Reform Department, 1989)[11]

The reform has increased financial resources at the disposal of local governments, and hence their decision-making power and accountability to their budgets. However, due to the lack of adequate coordination among various areas of the economy, the reform has to some extent encouraged the regional self-sufficiency tendency, and caused overlapped productions and constructions throughout the country.

Second, ever since the present reform started the Chinese leadership has, based on the lesson learned from previous reforms, made a great deal of efforts to search for an equilibrium to balance power between the sectoral "line" and the regional "block," or a substitution for the central government and the local government in organising economic activities on behalf of the state. This new substitution should be conducive to break down the long-standing compartmentalization by sectors and regions, and hence to free China from the vicious circle of centralization --- decentralization --- chaos --- re-centralization, characterized by previous reforms. It seems clear that many big and medium industrial and commercial cities have increasingly assumed this role.[12]

The essence of the new role is to coordinate various functions previously performed by ministries and local governments, organise economic activities in line with local comparative advantages, and hence to rationalize local

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[11]. The delivering amount for Guangdong was reduced to ¥1 billion and the subsidy amount for Fujian increased to ¥150 million later, because of the extra financial burden brought to the two provinces by the increases in the procurement prices of agricultural goods and in wages of urban workers and staff.

[12]. For more about the new functions performed by Chinese cities in the current reform, see Li Zhongfan *et al.* (1984); Dong Jialan (1984); and Liao Jili (1987).

industrial structure. The city reform has therefore been concentrated on restructuring city's economic planning and management system through separating government function and enterprise business. This is designed to cut off the close tie between ministries and local governments on the one hand and their subordinate enterprises on the other, and eventually to replace ministries and local governments with central cities to exercise macroeconomic management. As a result, three major changes have taken place (Zhou Taihe *et al.*, 1984; Wang and Zhu, 1987):

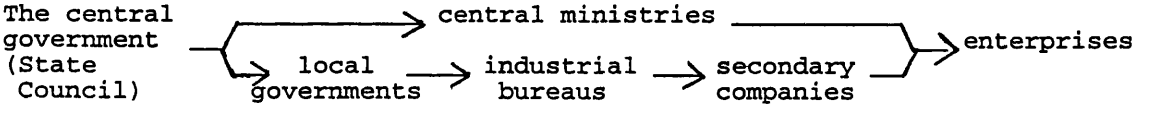
First, most central ministries, except those of Railway, Civil Aviation, and Post and Telecommunication, have no longer directly involved in enterprise operations. Instead, emphasis is put on making sectoral plan and long-term development strategy, enhancing R & D, providing technological training and advice, and coordinating utilization of equipment and input among related enterprises. The Ministry of Textile took a lead in this reform.

Second, many local governments have also relinquished or relaxed their control over enterprises. More affluent provinces, such Jiangsu and Liaoning, have devolved their powers to central cities, such as Nanjing, Suzhou, Shenyang and Dalian. At the same time, most central cities have been allowed to widen their jurisdiction to surrounding counties in order to increase their role in organising the local economy. For instance, Nanjing now includes seven neighbouring counties while Shenyang covers three.

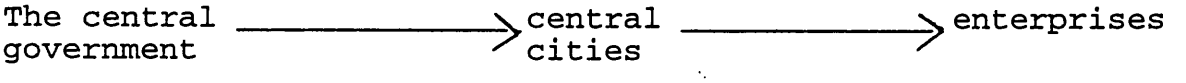
Third, cities themselves, on the other hand, are strengthening their new role and intensifying their "radioactivity" and "attractiveness." In order to avoid the central city becoming a new centralized control body, all original economic planning and management departments have been regrouped. Consequently, macro-management functions have been shifted from comprehensive governmental bureaus to specialized sectoral companies. Sixteen cities, including Dangdong, Weifan and Xiamen, were reported to have completed this reorganisation swiftly and successfully.

At the same time, a variety of economic zones based on regional growth have emerged. All these zones are centred by one or more key industrial cities. For example, the Shanghai Economic Zone, focused on Shanghai, includes Shanghai municipality and Jiangsu, Zhejiang, Anhui and Jiangxi four provinces. The Northeast China Economic Zone, supported by Shenyang, consists of Liaoning, Jilin and Heilongjiang three provinces. In addition to these interprovincial zones, some provinces have also set up intra-provincial zones, such as the Southern Fujian Economic Zone, backed by Xiamen, Quangzhou and Zhanzhou three cities, and the Pearl River Delta, centred by Guangzhou. By 1989, the number of all kinds of economic zones in China exceeded 100 (*RMRBh*, 10/5/89: 3).

As a result, central cities, together with their associated economic zones, have formed a new economic network in China, as against the vertically organised, ministerially directed development model of the previous command economy. Indeed, central cities are increasingly taking place of ministries and local governments and becoming a new intermediary level between the central government and enterprises. The pattern of macroeconomic planning and management has therefore shifted from:



to



Without doubt, the sectoral and regional segregation and autarky, which had plagued China's economy for more than three decades, has to a large extent been dismantled. It is in this sense that the emergence of central cities and economic zones can be regarded as a significant breakthrough in the present industrial reform (Tong Dalin, 1984).

3-1-5. The Relationship between the State and the Enterprise

Since China regards the invigoration of enterprises as the key link of the industrial reform, restructuring the relationship between the state and the enterprise naturally occupies the central position in the reform programme. All previous economic reforms concentrated on dividing administrative powers between the Centre and the locality and hence neglected to set up an appropriate relationship between the state and the enterprise (Liu Guoguang, 1980). In view of the lack of vitality in Chinese enterprises, the Reform Decision declares that "socialism with Chinese characteristics should, first and foremost, be able to instill vitality into enterprises" (Central Committee, 1984).

As the first attempt of the enterprise reform, 8 key SOEs, selected from Beijing, Shanghai and Tianjing, began to experiment on the scheme of increasing enterprise autonomy in May 1979. Then starting in 1981, a variety of economic responsibility systems were introduced in many enterprises. After June 1983, a new scheme that substitutes tax payment for profit remittance started to be implemented. These initial reform measures, mostly on a trial bias, were primarily designed to provide material incentives for enterprises and their workers and staff to pursue greater profits. They included: retention of a proportion of profits for workers' bonuses and welfare expenditures; special funds for small-scale investment; some freedom for enterprises in selling part of their outputs and in securing inputs; some flexibility in setting prices; and increases in managerial authority over production decision and personnel matters.

However, the crucial problem inherent in SOEs, the inseparability of government function and enterprise business, remained largely unsolved. Most SOEs were still appendages of their superior departments, and far from becoming independent producers. In fact, this inseparability is precisely the root of what Kornai identified as the most distinctive problem in SOEs --- "soft budget constraint" (Kornai, 1980). The

insatiable "hunger for investment" and the unproportionate increase in workers' welfare funds, both of which tend to intensify chronic shortage and inflation, are all caused by the fundamental problem.

By the late 1986 and early 1987, the Chinese economic circle seemed to have reached a consensus that the essence of the enterprise reform is to separate government function and enterprise business, or in other words, separate ownership and management, so as to make enterprises becoming an independent producer with both motive and constraining mechanisms.[13]

The principal way that China has tackled the inseparability since 1987 seems to be the so-called Contract Responsibility System (CRS), which is, in fact, a system similar to that operated in French SOEs. The essence of the CRS is to draw up the responsibilities, rights and interests for both the owner and the manager through a contract, which normally lasts for 5 years. Under the CRS, higher administrative authorities define specific tasks or responsibilities for enterprises and at the same time grant them all necessary managerial powers. Enterprises signing the contract must bear the responsibility for meeting production quotas, taxation and profit targets. The authorities on the other hand are responsible for ensuring that the market environment and other production conditions remain basically stable during the period of contract (Zhou Xiaochuan, 1988).

As a result, the close ties between the authorities and their subordinate enterprises have, to a large extent, been restructured, with the enterprises being given greater decision-making power. The CRS also safeguards enterprises against strong social reactions or political risks that price and tax reforms may bring about. Under the CRS, the failure of an enterprise to fulfil the targets set by the state will mean that the difference must be made up from its own funds. This helps strengthen financial disciplines on it and encourage it

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[13]. Many papers discussing the necessity to reconsider the reform strategy emerged in the late 1986 and early 1987. See, typically, Wu Jinlian (1987).

to behave rationally.

By the end of 1988, over 90 percent of the in-budget enterprises in the country had instituted a variety of CRSs. While 95 percent of large and medium SOEs had been involved in the system, about 46 percent of small SOEs had either been contracted out or leased to other organisations or even private (including foreign) individuals (ACE Editorial Board, 1989: III-4-6). Most of enterprises implementing such scheme have achieved better economic performances. By the end of 1990, 85 percent of enterprises had renewed their contracts after previous one matured (ibid, 1991: II-16).

In addition, many more enterprises in other parts of China have established a variety of joint-stock companies. According to a survey carried out in 20 provinces in 1988, the number of enterprises experimenting the reform stood at 3,800, of which 85 percent issued shares only to their own workers and staff, 13.5 percent attracted investment mainly from other organisations, and only 1.5 percent raised funds from the general public. At the same time, several prominent cities, such as Shenzhen, Shanghai, Shenyang and Wuhan, have set up or reopened their stock exchange (ibid, 1989: III-56).[14]

3-1-6. Reorganisation of Industrial Enterprises

As central cities have increasingly become the alternative to ministries and local governments in organizing macroeconomic activities, the integration of various economic activities has become an inevitable tendency. At the same time, the development of economic zones, backed by central cities, have made it necessary to increase specialization and

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[14]. The economic reform has also created a booming and dynamic non-state sector, especially township and village enterprises (TVEs), in China. Their share in the country's GVIO soared from 16 percent in 1984 to 31 percent in 1991. Indeed, some observers even argue that the creation and subsequent explosive expansion of TVEs has been the biggest achievement of China's present enterprise reform (Woo, *et al.* 1993: 19). As this thesis deals mainly with the reform of SOEs, the development of TVEs will not be discussed.

cooperation among sectors and regions, since the zones were set up primarily in the light of local comparative advantages.

W. Brus, an outstanding economist of centrally planned economy, noted that horizontal links between enterprises would play an important role in integrating plans at different levels in a decentralizing economy (Brus, 1973: 9). Liu Guoguang further argued that the inter-enterprise relationship is one of the most important relationships in the Chinese industrial reform (Liu, 1984: 48). As a matter of fact, economic development generally entails increasing interdependency and the emergence of a "circular flow" of goods and services linking, directly or indirectly, sectors and regions within a national economy. Thus, a growing number of horizontal economic associations (HEA) (*Henxiang Jingji Lianhe*) have emerged in China as a logical result of the sustained industrial reform.

Development of Horizontal Economic Associations

In China's present industrial reform, HEA refers to fusion and/or cooperation among enterprises in different sectors, regions and ownerships in order to improve economic efficiency, by increasing specialization and rationalizing organizational structures of industry and enterprise (Wang and Zhu, 1987: 979-80). Most associated entities are centred around one particular product or product group, especially, with famous brand(s). There are several motives for enterprises to form a HEA: 1). to secure the supply of scarce energy and/or raw materials; 2). to overcome severe space constraints on existing site(s); 3). to strengthen the competitiveness in marketing; 4). to even the imbalances in capacity at different stages of production; and 5). to gain access to the latest domestic or foreign technology and managerial know-how. So the HEA in China entails much wider range of economic activities than the horizontal merger in the

Western economy does.[15]

By 1988, the total number of HEAs in China had exceeded 10,000, involving more than 28,000 enterprises, which accounted for nearly 30 percent of the industrial enterprises above the county level, 55 percent of the country's total GVIO, and 63 percent of industrial profits and taxes for the same year. They achieved a high labour productivity of ¥22,200 per person per annum, almost 20 percent higher than the average level for all SOEs in China (*RMRBh*, 10/5/89: 3; *BR*, Feb. 23, 88). At the same time, many more agreements concerning economic and technological cooperations among enterprises all over the country have been signed each year, generating considerable amounts of GVIO, profits, and taxes. Table 3-1.1 below demonstrates these achievements.

Table 3-1.1 Number of cooperation agreements signed among Chinese industrial enterprises and economic results generated (1981 - 1990)

	1981-88	1989	1990
No. of agreements signed	410,000	74,000	52,560
Capital involved (¥ billion)	76.00	18.66	21.24
GVIO generated (¥ billion)	-------	44.38	43.00
Profits and taxes generated (¥ billion)	-------	7.60	8.60

Sources: 1). 1981-88: *RMRBh*, 10/5/1989, p. 3;
2). 1989: *RMRBh*, 28/5/1990, p. 1;
3). 1990: the Research Society (1991), p. 105.

The effects of the development of HEAs on the Chinese economy may be featured as follows:

First, perhaps the most obvious gain has been sharp increases in industrial output and profits due primarily to economies of scale and more efficient use of input factors.

[15]. In Western economies, horizontal merger is generally defined as the combining of activities at the same level of a vertical sequence of production (while vertical merger referring to the combining of successive production stages under one ownership). For details, see Jervis (1971).

For instance, it was estimated that about 60 percent of the increased GVIO and 70 percent of the increased profits and taxes in Jilin in 1986 came from the newly formed industrial corporations and associations in the province (*GYJJ*, 7/87: 79).

Second, the proliferation of HEAs has accelerated the breakdown of the compartmentalization of "regional blocks" and "sectoral lines" and facilitated the formation of the new network of horizontal-linked and market-oriented economic zones and central cities. By 1989, almost every province in mainland China, except Tibet, had set up inter- and/or intra-provincial economic zones, which numbered more than 100 in total (Research Society, 1991: 105).

Third, the formation of HEAs is an effective way to ensure the enterprise to become an independent producer. By forming a HEA with enterprise(s) in other sector(s) or region(s), an enterprise can to a large extent extricate itself from the control of and hence the interference from its former superior administrative bodies. The relationship between the state and the enterprise would then become merely that of registration and taxation.

Furthermore, HEAs have expedited the restructuring of China's sole state-ownership system. The integrations between SOEs and COEs, between public-owned and private-owned enterprises, and between Chinese and foreign enterprises have resulted in a variety of forms of mixed ownerships, creating the embryo of a mixed economy in China.

Fourth, HEAs have served as catalyst in the organisational restructuring of Chinese enterprise. Indeed, the flourish of HEAs nationwide has led to the expansion of the size of Chinese enterprises. More and more large-scale integrated organisations, such as enterprise groups and consortia, consisting of from a dozen to more than a hundred small and medium enterprises, have emerged. By 1990, the number of such group and consortia had reached 1,630, 14 of which are known as "Industrial Giants" in China today. Indeed, they so vital to the Chinese economy that they have been

granted the privilege of "independent planning" (*RMRBh*, 10/5/89: 3).

Fifth, HEAs have greatly increased the mobility of factors of production and speeded up the development of factor markets in China. In 1990 alone, for example, a total amount of ¥21.24 billion capital was involved in various cooperation projects in China. At the same time, professional people and skilled labours have more freedom to move among associated plants, especially from more advanced to less advanced one, and twenty-one exchange fairs were held nationwide in 1990 to promote such free movement of human resources (Research Society, 1991: 106).

And finally, HEAs have immensely facilitated the inflow of FDI and promoted the development of the SEZs. In particular, the five SEZs and fourteen open costal cities have forged a new type of HEA --- the interior-local-foreign partnership. As a distinctive Chinese way of developing EPZ-type zone, this kind of cooperation has played a crucial role in strengthening the SEZs' industrial and technological capacities, improving their infrastructures, and raising their economic efficiency of transferring foreign advanced technology and management expertise into the interior.[16]

3-1-7. Performance and Problems

The above discussions suggest that the industrial reform is transforming the old, centrally planned economy into a new, mixed economy, with growing shares of private elements and market-oriented horizontal economic activities. As can be seen from Table 3-1.2, China's GVIO, national income and its per capita level have all registered a higher growth rate in the reform period of 1978-90 than in the prereform one of 1952-78 (8.39%, 12.00% and 12.33% vs. 5.99%, 11.41% and 4.35%, respectively). Indeed, the Chinese economy has been among the fastest growing economies in the world in the last decade or

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[16]. For more about the introduction of FDI in China and the development of the SEZs, see Chapter 4.

so, and China's incremental or gradual approach towards the reform has increasingly been judged as appropriate, especially compared with the "big-bang" strategy adopted by the former Soviet Union and Eastern European countries.

Table 3-1.2 Growth of China's GVIO, national income and national income per capita (1952 - 1990)

	National income	GVIO	National income per capita
	(¥100 m., in 1952 prices)		(¥/per yr, in current prices)
1952	589	349	104
1978	2,671	5,790	315
1979	2,857	6,300	346
1980	3,041	6,883	376
1981	3,189	7,179	397
1982	3,450	7,740	422
1983	3,794	8,606	463
1984	4,311	10,007	545
1985	4,892	12,148	668
1986	5,269	13,565	737
1987	5,806	15,965	859
1988	6,463	19,284	1,066
1989	6,698	20,930	1,178
1990	7,019	22,555	1,271
Annual average rates of growth (%)			
1952-78	5.99	11.41	4.35
1978-90	**8.39**	**12.00**	**12.33**
1952-90	6.74	11.59	6.81

Sources: 1). National income and national income per capita: SSB (1991), pp. 32-3.
2). GVIO: SSB (1991), pp. 54-5.

However, in order to achieve a sustained growth of the economy it is vitally important to raise industrial productivity. In the preceding chapter, we have shown that it was the persistent stagnation and, in some cases, even deterioration of the TFP of the industry during the prereform period which had led to the present reform (see Table 2-3.2 and 2-3.3). After more than a decade of reform, one would inevitably wonder what has happened to the crucial economic indicator?

Table 3-1.3 is an extension of Table 2-3.2, including the reform period of 1978-90. It shows that the pace of the increase in labour input has slowed down noticeably in the reform period, with the annual growth rate dropping to 3.06 percent from 7.11 percent in the prereform period of 1952-78. At the same time, the speed of capital injection has also gone down slightly, with the rate declining from 12.58 percent to 11.69 percent. This shift of the development strategy from "extensive growth" to "intensive growth" has led to a massive increase in the labour productivity, from 4.01 percent to 8.68 percent, and a fundamental improvement in the capital productivity, from *negative* 1.13 percent to *positive* 0.48 percent.

Table 3-1.3 Growth rates of output per worker and per 100 yuan of capital in Chinese industrial enterprises (1952 - 1990)

(1952 = 100)

	(1) GVIO	(2) No. of workers (year end)	(3) Fixed & working capital	(4) Output per worker [(1)/(2)]	(5) Output per ¥100 of capital [(1)/(3)]
1952	100.00	100.00	100.00	100.00	100.00
1978	1659.03	596.27	2175.34	278.24	74.41
1990	6462.75	855.69	8199.46	755.29	78.82
Average annual rates of growth (%)					
52-78	11.41	7.11	12.58	4.01	-1.13
78-90	**12.00**	**3.06**	**11.69**	**8.68**	**0.48**
52-90	11.59	5.81	12.30	5.46	-0.62

Sources: 1). 1952-78: Table 2-3.2;
2). 1990: GVIO: Table 3-1.2; Workers & Capital: SSB (1991), pp. 105 & 410.

Similarly, Table 3-1.4 is an extension of Table 2-3.3, including the reform period. It reveals a corresponding change in the TFP: regardless of which of two labour weights is applied the productivity has registered a marked growth in both cases. In the case of the greater weight of 0.6, the growth rate of the productivity goes up from 1.16 percent per

year in the prereform period to 1.95 percent per year in the reform period; while in the case of the smaller weight of 0.4, the rate climbs from 0.28 percent per year to 1.12 percent per year. Without doubt, this crucial achievement suggests that the economic efficiency of China's industry is improving and the industrial reform is producing tangible and positive results.[17]

Table 3-1.4 Growth rates of industrial output, total factor input and total factor productivity (1952 - 1990)

(1952 = 100)

	Total factor input index assuming labour share of:			Index of output per unit of combined inputs at assumed labour share of:	
	0.6	0.4	GVIO index	0.6	0.4
1952	100.00	100.00	100.00	100.00	100.00
1978	1227.90	1543.71	1659.03	135.11	107.47
1990	3793.20	5261.95	6462.75	170.38	122.82
Average annual rates of growth (%)					
1952-78				1.16	0.28
1978-90				**1.95**	**1.12**
1952-90				1.41	0.54

Sources: 1). 1952-78: Table 2-3.3;
2). 1990: Table 3-1.3.

On the other hand, one cannot ignore the fact that the contribution from the growth of the TFP to that of GVIO is still disappointedly small, only ranging from 5 to 15 percent. For example, the contribution for the whole period of 1952-90 was 1.41 percent, in the case of the weight of 0.6, or 0.54 percent, in the case of the weight of 0.4. However, the growth rate of GVIO for the same period is 11.59 percent per year. This implies that the increase in the total factor input

[17]. Woo, *et al.* (1993) suggests that the growth of the TFP in the Chinese industry during the reform period came largely from fast-expanding COEs and TVEs, instead of SOEs (p. 3).

accounts for the rest 10.18 percent (= 11.59%-1.41%), in the case of the weight of 0.6, or 11.05 percent (= 11.59% - 0.54%), in the case of the weight of 0.4.

Table 3-1.3 tells the reasons for the obviously dissatisfactory performance during the whole period of 1952-90. The principal cause has been the long-standing *negative* growth of the capital productivity (-0.62% per annum). This can be explained by the fact that the growth of capital injection was faster than that for GVIO (12.30% vs 11.59%). At the same time, although the labour productivity has achieved an overall increase of 5.46 percent per annum, it was outweighed by the even higher growth of labour input (5.81% per annum). As a result, the overall growth of the TFP naturally remained sluggish. This suggests that the industrial reform has still some way to go to rejuvenate inefficient enterprises, particularly large- and medium-sized SOEs.

On the whole, the industrial reform has so far been piecemeal and uncoordinated, with much experimentation and modification to cope with unforseen problems. Many new indirect regulatory mechanisms cannot be applied, or applied effectively, due to the lack of appropriate microeconomic conditions. On the one hand, the state has either lifted or relaxed its direct control over enterprises. On the other hand, enterprises have yet become cost-sensitive and been able to behave rationally and responsibly, since much of distortions in the economic system remains largely uncorrected.[18] That is to say, a "vacuum" has been created in the Chinese macroeconomic management. As a result, the economic development in the recent years has been consistently troubled by the following three major problems:

First, recurrent boom-bust cycles caused by the

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[18]. Kornai argues that both enterprise behaviour and state economic management possess dualistic features in the period of the coexistence of new and old economic systems. The enterprise would, he describes, keep one eye on the market and the other on the state; the state, on the other hand, has to use some market mechanisms as well as direct administrative means to regulate the enterprise. This seems to be the situation currently existing in China. See Kornai (1980).

overheating of the economy and the subsequent implementation of austerity measures. Inflation in many years approached double-digit level.

Second, imbalance development between infrastructures and basic industries, on the one hand, and light and processing industries, on the other, due largely to the overexpansion of the latter. As a result, the traditional "bottleneck" has been intensified.

And third, little improvement in the economic efficiency of many SOEs, especially large ones, owing to the reluctance of the state to apply tougher financial disciplines to them.

3-2. The Foreign Trade Reform[19]

By the late 1970s, the PRC had been isolated from the rest of the world for more than two decades. The new, pragmatic post-Mao leadership, led by Deng Xiaoping, realised that an isolated China would remain poor and week, and that an autarkic strategy of development would prevent China from absorbing advanced technology of other countries. As a result, in addition to the industrial reform, the Third Plenum has also made another important strategic decision --- open China to the world economy --- in order to achieve its ambitious modernization programmes. Zhao Ziyang, then Chinese premier, explained the importance of implementing the "open-door" policy:

> By linking our country with the world market, expanding foreign trade, importing advanced technology, utilizing foreign capital, and entering into different forms of international economic and

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[19]. N. R. Lardy (1992a) has provided the most comprehensive and detailed study so far on China's present foreign trade reform and hence is the major source of information for this section. Apart from it, the ACFERT Editorial Board (1985), (1986), (1987), (1988) and (1991); JEC (1992), chiefly Chapter V; Lardy (1992b); the World Bank (1988a) and (1990); the Topic Group (1987); Panagariya (1991); Ross (1987) and (1988); Xue Muqiao (1986); Imai (1985); Clarke (1984); and Morino (1982) have also provided some important accounts on the reform.

> technological cooperations, we can use our strong points to make up for our weak points through international exchange on the basis of equality and mutual benefit (Zhao, 1982a: 47).

Thus, the open door policy, as an integral part of China's new development strategy, represents the greatest policy shift in China since 1976. Its impacts on the economy have been, in magnitude, almost as profound as the development in agriculture after 1978 (Riskin, 1987: 316).

3-2-1. Reform Policies and Changes

The foreign trade reform started in July 1979, with the introduction of a flexible foreign trade policy in Guangdong and Fujian provinces. However, an all-round and radical restructuring did not start until September 1984, when the State Council approved the report submitted by the newly created Ministry of Foreign Economic Relations and Trade (MOFERT) on Reform of China's old Foreign Trade System (see Appendix B).[20] The Report, representing the most update form of decentralization ever proposed in a centrally planned economy, has laid a solid foundation for subsequent trade reforms in China. The general thrust of the Report was toward a devolution of power from the centre to lower levels of administration. Many reform measures recommended by it have been implemented and they have resulted in a lot of remarkable changes in the foreign trade system.

1. *Decentralization and Proliferation of Trading Firms*
One of the earliest steps taken by the Chinese government to decentralize its foreign trade system has been to devolve the power to conduct foreign trade transactions from the central government to local governments, industrial ministries and some key manufacturing enterprises. This means that the central government has in effect given up the monopoly on foreign trade it had exercised since the mid-1950s. In

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[20]. For a Western interpretation of the Report, best see Satoshi Imai (1985).

addition to Guangdong and Fujian, many other provinces have also enjoyed autonomy in importing and exporting a lot of goods through their own, newly established trading firms.

At the same time, some central ministries have also established their own trading corporations to specialize in the trade of their own manufactured goods. Furthermore, more than 130 large and key manufacturing enterprises have also been allowed to conduct foreign trade directly. As a result, the number of trading entities in China soared, from less than a hundred before the reform to 1,200 at the end of 1986 (Topic Group, 1987: 33) and to 5,000 in 1990 (Lardy, 1992a: 39).

2. *Implementation of Foreign Exchange Retention Scheme*

In order to encourage exports, since 1979 the Chinese government has instituted an elaborate system of foreign exchange retention (*Waihui Liucheng Zhi*), which entitles both export-producing enterprises and their superior authorities the right to use a part of foreign exchange earnings from their exports. This represents a significant diminution for the Chinese authorities in the monopoly control of foreign exchange.

The rate of retention varies by region and industry and changes from time to time. According to the 1991 regime, for most goods, 20 percent retention rights are allocated to the central government, 10 percent to provincial and local governments, 10 percent to enterprises, and 60 percent to FTCs (Panagariya, 1991: 14). For the SEZs and other open areas, the rate is 100 percent, while for those priority sectors, such as machinery and electrical goods, the rate goes as high as 70 or even 100 percent. Foreign exchange acquired under this way can be either used to import materials and equipment for further production or to carry out marketing surveys abroad, or sold for specific purposes in a Foreign Exchange Adjustment Centre (FEAC). By 1988, retained foreign exchange totalled US$18.5 billion, over 40 percent of China's total export earnings (Lardy, 1992a: 57). Clearly, the system has to some extent offset the negative effect of the overvalued exchange rate and the low Renminbi prices paid by FTCs on exports.

3. *Separation of Governmental Functions and Business Operations* A central task of the reform is to separate government administration and enterprise business by confining the MOFERT and its subordinate committees to administrative affairs and thus refraining them from intervening in day-to-day trading businesses of enterprises directly. The main responsibilities of the MOFERT have been defined as those of making policy, working out long-term trade strategy and plans, setting targets for annual exports and imports and supervising their implementation, examining applications for and issuing export and import licences, and allocating export and import quotas.

4. *Introduction of the CRS* Under the CRS, all provincial-level localities are required to sign annual contracts with the MOFERT, specifying their projected total export value, foreign exchange earnings, costs of earning foreign exchange, basic amount of renminbi subsidy needed, and overall profits (or losses). To meet these targets, provincial MOFERT commissions sign similar contracts with their subordinate bodies, provincial FTCs, municipal and county commissions, which, in turn, sign contracts with FTCs in the cities and counties under their jurisdiction. Finally, all FTCs sign export or import contracts with manufacturing enterprises or end-users.

5. *Rationalization of Foreign Trade Planning* On the export side, the old mandatory plan has been largely replaced by a "guidance plan," which merely lists the value indices of total exports and foreign exchange earnings. Although a few strategically important items remain in the quantitative, mandatory plan, the number of them has fallen all along time, from some 3,000 in the prereform period to 199 in 1982 and to 112 in 1988 (ibid: 40). At the same time, procurement and allotment plans have been abolished. On the import side, the government has stopped compiling the category of importing commodities. Trading companies and manufacturing enterprises which have the authority to conduct foreign business directly are allowed, in principle, to import approved goods, provided

they can balance their own foreign exchange accounts. As a result of the above changes, the shares of both planned exports and imports fell from about 90 percent for both in the late 1970s to 45 percent for exports and 40 percent for imports in 1988 (ibid: 40-1).

6. *Establishment of Export- and Import-Agency System* Under the system, which was introduced since 1985, export or import operation is conducted, on a consignment basis, by a trading company which receives a commissions for its efforts from the manufacturer, in the case of exports, or the user, in the case of imports. That is to say, enterprises themselves, instead of trading companies, bear the responsibility for all profits and losses of the transaction. As domestic prices of both export and imported goods are linked to international prices via the exchange rate under this system, the most critical component of the traditional "airlock system," which had insulated China from the world economy over years, has virtually been eliminated.

7. *Reform of Foreign Trade Pricing* The liberalization of foreign trade pricing accelerated in the mid-1980s when the use of the agent system in export and import was introduced. On the import side, goods imported under the agent system are subject to "foreign trade agent price formation" (*Waimao Daili Zuojia*). This means that the import price multiplying the exchange rate forms the basis of the domestic price, to which are added the customs tax, product tax or value added tax, bank charges, and the handling fee of the agent. The share of imported goods priced on the basis of the import costs rose from around 20 percent in 1984 to 90 percent in the mid-1990. (ibid: 74 & 76). This reform has resulted in a substantial erosion of the import substitution character of China's old trade regime, and made users of imported goods to pay higher domestic prices and hence more sensitive to the world prices of goods they use.

On the export side, however, the picture of change seems less clear. Depending on the product, procurement prices for exports in terms of Renminbi are set differently. For category

one exports specified in the foreign trade plan,[21] traditional pricing appears to still be applied. That is to say, FTCs continue to purchase planned quantities of these export goods from domestic producers at the same state-fixed price as comparable goods sold on domestic markets. For category two goods, containing 91 products, which were covered under the guidance plan, some of them were priced in the old fashion, i.e. at ex-factory prices, while others, especially the above-plan portion, were subject to more flexible regime. Finally, for category three goods, accounting for 55 percent of total exports, the agent system is widely applied and hence prices are set largely on the basis of the international market conditions.

8. *Restructuring of Foreign Exchange Rate and Management System* To implement its export promotion strategy the Chinese government has consistently reviewed its exchange rate policy and relaxed exchange control ever since the reform started. From 1980 to 1990 Renminbi had been devalued several times with the result that the exchange rate changed from the ratio of ¥1.530 to one dollar to that of ¥5.222 to one dollar (see Table 3-2.1). At the same time, many measures were taken to relax foreign exchange control, including allowing other Chinese banks, apart from the Bank of China, to engage in foreign exchange dealings.

Table 3-2.1 China's exchange rates (1980 - 1990)
Yuan per US dollar

1980	1981	1982	1983	1984	1985	1986-88	1989	1990
1.530	1.746	1.923	1.981	2.796	3.202	3.722	4.722	5.222

Source: The ESCAP (1991), p 87.

But the most important development in the area of foreign

[21]. They included crude oil, refined petroleum products, coal, tungsten, antimony, tea, tobacco, rice, corn, beans, bean products, cotton yarn and grey goods, cotton-synthetic yarns and grey goods, raw silk, and cloth, etc..

exchange control in recent years has been the establishment of FEACs, or swap centres. By August 1989, there were as many as 90 of them in operation (Panagariya, 1991: 8). The primary function of FEACs is to facilitate purchase and sale of retained foreign exchange at more or less market clearing rate albeit for specific purposes within the rules laid down by the centres. In 1988 alone, a total of US$6.26 billion, making up 33.85 percent of foreign exchange retained by enterprises, was traded at these centres (ibid). By 1990 the transaction volume reached staggering US$13.2 billion (Lardy, 1992a: 61).

9. *Imposition of Export and Import Licensing System* Apart from generally controlling the volume and commodity composition of trade, the licensing system, which was introduced in June 1980, is intended to restrict unplanned imports financed through retained foreign exchange earnings and stem the flow of "parallel goods," i.e. goods being sold through unofficial channels at lower than state prices to the outlets mostly in Hong Kong and Macau.[22] Both export and import licenses are divided into three categories according to the importance of commodity concerned.[23] By 1989, the number of export commodities requiring licenses had risen from 24 in 1981 to 173 while import goods from 21 in 1982 to 53. At the same time, the share of exports under license reached 55 percent whereas imports 46 percent (ibid: 44). The adoption of licensing in China should be regarded, according to N. R. Lardy, as a progress of transition from Krueger's stage one to stage two in the process of liberalizing an import substitution trade regime (ibid: 43).[24]

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[22]. See the *Provision of Export Licence System*, issued by the State Council in June 1980, in the ACFERT Editorial Board (1984).

[23]. For more about the classification and explanations of the three categories, see Panagariya (1991), pp. 8-10.

[24]. Krueger (and Bhagwati as well) divides a developing nation's foreign trade liberation into five stages --- highly administrative management and quantitative control; introduction of elaborate controls by economic levers; rationalization of exchange rate; all-round replacement of

10. *Promotion of Linkage between Industry and Trade* A great deal of effort has been made to encourage direct contacts between export manufacturing enterprises and trading companies in order to improve efficiency of foreign trade. As a result, many foreign-trade-oriented HEAs have emerged in the country since the early 1980s. Some big enterprises even set up their own trading companies. *China Jinshan Allied Trade Corporation* in Shanghai and *Yanshan General Petrochemical Corporation* in Beijing are examples of this practice.

11. *Development of Export-Production Networks* In order to raise competitiveness of Chinese exports, some key, advanced enterprises and farms within target industries or areas have, since 1979, been chosen as "specialized production bases for export." They are encouraged to move into higher value added exports, improve quality and increase varieties.

China has decided to target the following three product groups as its major export goods in the next 10-20 years: machinery and electrical goods, light industrial and textile goods, and agricultural and sideline products. By the end of 1987, exports of the first group of products had already hit US$100 million or more (Panagariya, 1991: 12).

12. *Diversification of Foreign Trade Forms* To promote exports the Chinese government has also actively promoted other forms of trade, in particular compensation trade (*Buchang Maoyi*) and export processing (*Chukuo Jiagong*). Under the former arrangement, a foreign firm supplies technology or equipment to a Chinese enterprise in exchange for goods produced with that technology or equipment. This makes it possible for Chinese enterprises to acquire foreign capital goods without access to foreign exchange. The latter arrangement includes both the processing of imported raw

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unnecessary administrative means with economic and price mechanisms, and full convertibility of domestic currency. See Krueger (1978), pp. 24-6. On the other hand, Zhou Xiaochuang (1988) roughly agrees that China's reform is in the process of transition from the first stage to the second. For more about the differentiation of the reform's stages, also see Sung Yun-wing (1987).

materials for export, the assembly of imported components to produce exportable final goods, and certain other type exports. From 1981 to 1987, for example, compensation trade had grown by 3.8 times, while export processing by 14 times, far exceeding the 42 percent growth in normal trade (*BR*, Oct. 10-16, 88: 24).

13. *Other Export Promotion Measures* Export credits has played an increasingly important role in promoting China's exports since the early 1980s, especially helping insulate exporting firms from the effect of recurrent economic austerity programmes. In 1988 and 1989 domestic currency loans outstanding to export-oriented enterprises and trading companies reached ¥100.8 billion and ¥120 billion, respectively, two times more than the figure of 1984 (Lardy, 1992a: 80).

At the same time, China has also actively made used of tariff and tax as trade policy instruments. In 1985 the various import and export tariffs that had been announced in the previous five years were published in the first comprehensive tariff schedule released since 1951. This was followed by the release of a comprehensive customs schedule in September 1989, the first in several years. With the growing volume of trade, China's tariff revenues soared, totalling ¥49.7 billion in the period of 1980-85. This figure, more than twice the entire amount collected during 1953-79, accounted for 15 percent of the total import value for the same period, compared with only 11 percent in the prereform era (ibid: 47).

The most important change in China's domestic tax structure was that the State Council approved a system in 1985 to rebate to producers a portion of the indirect taxes paid on export goods. As a result, the amount rebated increased sharply from ¥1.8 billion in 1985 to staggering ¥12 billion in 1988, making up about 7 percent of the total export value of the year (ibid: 50). Clearly, the reform of tax structure has brought China's foreign trade system into greater conformity with the GATT charter.

Thus, there can be no doubt that the foreign trade reform

in the 1980s has profoundly transformed the structure of China's foreign trade and foreign exchange management systems, and to some extent improved the efficiency of external dealings. Indeed, foreign trade has ceased to be a residual but become the most dynamic sector of the economy, catalyzing the national economic development.

3-2-2. Performance and Problems

The foreign trade reform has brought about a profound change in China's trade performance since the late 1970s. As can be seen from Table 3-2.2, in 1990 the total trade value

Table 3-2.2 Growth of China's foreign trade during the reform period of 1978-90
(US$100 million)

Year	Total trade volume	% over previous year	Exports	% over previous year	Imports	% over previous year
1978	206.38	----	97.45	----	108.93	----
1979	293.33	42.1	136.58	40.2	156.75	43.9
1980	378.22	28.9	182.72	33.8	195.50	24.7
1981	403.75	6.8	208.93	14.3	194.82	-0.3
1982	392.97	-2.7	218.19	4.4	174.78	-10.3
1983	407.27	3.6	221.97	1.7	185.30	6.0
1984	497.72	22.2	244.16	10.0	253.56	36.8
1985	602.46	21.0	259.15	6.1	343.31	35.4
1986	600.97	-0.2	270.14	4.2	330.83	-3.6
1987	681.10	13.3	347.11	28.5	333.99	1.0
1988	804.90	18.2	406.40	17.1	398.50	19.3
1989	825.83	2.6	434.40	6.9	391.43	-1.8
1990	851.18	3.1	520.67	19.9	330.51	-15.6
Annual average rates of growth (%)						
1952-78		9.52		9.97		9.15
1978-90		**12.53**		**14.99**		**9.69**
1952-90		10.46		11.53		9.32

Source: The ACFERT Editorial Board (1991), pp. 317 & 319.

hit US$85.118 billion, more than 3 times greater than that in 1978. This has resulted in a high annual average growth rate of 12.53 percent between 1978 and 1990, compared with only

9.52 percent for the prereform period of 1952-78. Exports, in particular, has played a key role in boosting the trade growth by expanding at the speed of nearly 15 percent per year, with five percentage points ahead of the rate for the prereform period (9.97%). More significantly, export growth in most years of the reform period has been substantially higher than import growth, with the annual average rate of growth leading by more than 5 percent (14.99% vs. 9.69%). As a result, China's trade surplus soared, reaching US$19.016 billion in 1990 alone.

At the same time, like other liberalizing import substitution regimes, expanded foreign trade has promoted, or at least coincided with, an exceptionally fast growth of the Chinese economy. As exhibited in Table 3-1.2, the annual average rate of growth for China's national income in the reform period registered 8.39 percent, compared with 5.99 percent for the prereform period.

Table 3-2.3 shows a comparison of average annual rates of growth of foreign trade between China and several selected countries or regions during the period of 1978-90. By the IMF calculation, China's total trade volume grew by more than 15 percent per year,[25] not only substantially higher than the average levels of developing countries, developed countries and the world as a whole (7.56%, 9.09% and 8.67% respectively) but also slightly higher than that of world's most successful exporting economies --- the NICs (15.05%). Indeed, only Thailand and Hong Kong grew faster than China in that period. More spectacularly, China has achieved the second fastest growth in terms of exports (16.35%), only behind Hong Kong.

Not surprisingly, the degree of openness of the Chinese economy has increased drastically, with its share of total trade volume in GNP has jumped sharply from 9.95 percent in 1978 to 23.38 percent (ACFERT Editorial Board, 1991: 323), or according to the IMF calculation, 30.78 percent (IMF, 1992:

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[25]. Compared with the data from other sources, the data compiled by the MOFERT, are generally biased downward. For the explanation of this difference, see Lardy (1992a), pp. 12-3.

281), in 1990.[26] The IMF ratio in 1990, though lower than those of developing countries with export-oriented economies, the four NICs and some Western market economies, compares

Table 3-2.3 Foreign trade performances in several selected countries/regions (1978 - 90)

(%)

	Average annual rates of growth (1978-90)			Shares of total trade volume in GNP (1990)
	Total	Exports	Imports	
China (MOFERT)	12.53	14.99	9.69	23.38
(IMF)	15.08	16.35	13.80	30.78
Brazil	5.69	7.84	3.39	30.21
India	9.16	8.61	9.61	13.86
Indonesia	8.26	6.81	10.36	47.81
Malaysia	13.14	12.17	14.23	144.78
Philippines	7.83	7.46	8.06	49.13
Thailand	16.07	15.52	16.47	81.84
All developing countries	7.56	7.49	7.63	-----
Hong Kong	17.07	17.85	16.35	231.80*
South Korea	14.11	14.57	13.69	55.66
Taiwan	14.61	14.89	14.28	83.84
Singapore	14.16	14.74	13.69	318.42
The four NICs	15.05	15.58	14.56	------
Japan	9.39	9.37	9.42	17.57
Australia	8.65	8.84	8.47	29.19
Germany	9.16	9.21	9.10	50.10
U. K.	9.09	8.72	9.41	41.58
U. S. A.	8.77	8.62	8.89	16.48
All developed countries	9.09	9.16	9.11	-----
Asia	13.38	13.56	13.22	-----
The world	8.67	8.62	8.71	-----

* The share of total trade volume in GDP.

Sources: 1). China's figures in the top line: the ACFERT Editorial Board (1991), pp. 317; 323;
2). Hong Kong's share of total trade volume in GDP: *Hong Kong Monthly Digest of Statistics*, Nov. 1991, pp. 1; 19; 105;

[26]. There have been different views on the calculation and accuracy of China's trade ratio. See chiefly Lardy (1992a), *Appendix B*.

3). Taiwan's share of total trade volume in GNP: *Caijing Jishi* (The Databank Review), Nov. 1991, pp. 13-4;
4). The rest of the data: IMF (1992).

favourably with those of similar large-size countries or countries with a huge domestic market, such as India, U.S.A., Japan, Australia and Brazil.

The rapid and sustained growth of foreign trade has significantly increased China's role in the world economy. The share of China's exports in the world's total exports rose from 0.75 percent in 1978 to 1.80 percent in 1990, while its ranking as an exporting nation jumped from the thirty-second to the fifteenth place (ACFERT Editorial Board, 1991: 322).

Table 3-2.4 Commodity composition of China's imports (1979 - 1990)

(By SITC system)

(US$100 million)

Yr.	Primary goods						Manufactured goods					
	Total	%	(1)FS.	%	(3)Nf.I.	%	Total	%	(1)H.C.	%	(2)L.T.	%
79	44.22	28.2	22.64	14.4	18.49	11.8	112.53	71.8	105.42	67.3	7.11	4.5
80	69.20	35.4	31.41	16.1	33.70	17.2	126.30	64.6	110.58	56.6	15.72	8.0
81	78.63	40.4	38.46	19.7	37.47	19.3	116.19	59.6	96.88	49.6	19.51	10.0
82	73.25	41.9	39.07	22.4	30.31	17.3	101.53	58.1	87.92	50.3	13.61	7.8
83	54.33	29.3	28.44	15.3	23.52	12.7	130.92	70.7	117.03	63.2	13.89	7.5
84	56.76	22.4	20.42	8.1	33.95	13.4	196.80	77.6	176.66	69.7	20.14	7.9
85	58.59	17.1	15.63	4.6	37.58	11.0	284.72	82.9	251.43	73.2	33.29	9.7
86	49.28	14.9	16.39	5.0	25.27	7.6	281.55	85.1	238.73	72.2	42.82	12.9
87	70.92	21.2	23.14	6.9	36.03	10.8	263.07	78.8	220.44	66.0	46.63	12.8
88	80.88	20.3	32.73	8.2	36.51	9.2	317.62	79.7	259.26	65.1	58.36	14.6
89	101.34	25.9	38.67	9.9	44.96	11.5	290.09	74.1	273.39	69.8	16.70	4.3
90	89.41	27.1	32.48	9.8	42.32	12.8	241.10	72.9	221.86	67.1	19.24	5.8

Note: The total imports/exports normally consist of primary products and manufactured goods. The former includes: (1) Foodstuffs (short for "FS."); (2) Beverages and tobacco; (3) Non-food items ("Nf.I."); (4) Mineral fuels (for "M.F."); and (5) Animal and vegetable oils and fats. The latter, on the other hand, contains: (1) Heavy industrial and chemical products ("H.C."); and (2) Light industrial and textile products ("L.T.").

Sources: 1). 1979-83: The ACFERT Editorial Board (1984), p. 831;
2). 1984-90: The ACFERT Editorial Board (1991), p. 329.

In terms of commodity structure, China's imports have not experienced any significant change during the reform period of 1979-90 due largely to the inelasticity of demand in the domestic market for the import goods, such as grains, industrial raw materials and capital equipment (see Table 3-

2.4). On the export side, however, a fundamental change in export structure has taken place. As shown in Table 3-2.5, from 1978 to 1990, the share of primary goods declined steadily from 53.5 percent to below one-third while that of manufactured goods rose steeply from 46.5 percent to over two-third. Also, it can be seen from the table that from the late 1970s to the mid-1980s exports of mineral fuels (shown in the table as "M.F."), or more precisely petroleum, played an important role in boosting the export growth, accounting for 28.3 percent of China's total exports in 1985.[27] After 1985 this pattern began to change and exports of manufactured goods, in particular light industrial and textile products ("L.T."), became the major source of China's exports, reaching an all-time high in 1989 (43.8%). The changing commodity composition of China's exports reflects China's increasing sensitivity to, and ability to adapt to, the changes in the world market conditions.

Table 3-2.5 Commodity composition of China's exports (1979 - 1990)

(By SITC system)

(US$100 million)

Yr.	Primary goods						Manufactured goods					
	Total	%	(1)FS.	%	(4)M.F.	%	Total	%	(1)H.C.	%	(2)L.T.	%
78	52.16	53.5	23.16	23.8	13.45	13.8	45.29	46.5	10.10	10.4	35.19	36.1
79	73.15	53.6	27.01	19.8	26.54	19.5	63.43	46.4	14.97	10.9	48.46	35.5
80	97.62	53.4	31.54	17.3	45.88	25.1	85.10	46.6	23.57	12.9	61.53	33.7
81	103.60	49.6	30.71	14.7	50.54	24.2	105.33	50.4	37.98	18.2	67.35	32.2
82	104.63	48.0	30.94	14.2	53.53	24.5	113.56	52.0	49.11	22.5	64.45	29.5
83	102.65	46.2	32.24	14.5	47.01	21.2	119.32	53.8	48.71	22.0	70.61	31.8
84	121.79	49.9	35.09	14.4	60.62	24.8	122.37	50.1	46.99	19.2	75.38	30.9
85	140.34	54.2	40.27	15.6	73.34	28.3	118.81	45.8	36.05	13.9	82.76	31.9
86	117.92	43.7	49.86	18.5	35.82	13.3	152.22	56.3	55.29	20.4	96.93	35.9
87	134.52	38.8	50.54	14.6	48.34	13.9	212.59	61.2	72.59	20.9	140.00	40.3
88	144.53	35.6	62.79	15.5	40.14	9.9	261.87	64.4	99.70	24.5	162.17	39.9
89	150.86	34.7	63.07	14.5	46.15	10.6	283.54	65.3	93.15	21.5	190.39	43.8
90	167.95	32.3	67.90	13.1	58.93	11.3	352.72	67.7	137.48	26.4	215.24	41.3

Source: The ACFERT Editorial Board (1991), pp. 326-7.

[27]. In fact, from 1977 to 1985 China's exports of crude oil and refined petroleum products grew from 12 to 36 million metric tons and the value of petroleum exports rose by almost $6 billion. See Lardy (1992b), p. 698.

All these changes, paralleling the situation in most of the NICs in the early 1970s, clearly indicate that China's trade liberalization has made significant progresses, and that the economy is gradually moving from the closed, import-substitute system to an open, more export-oriented mode.

However, it is obvious that the trade reform has not solved all the old problems inherited from the previous trade regime. At the same time, new problems have emerged as a result of the reform. These problems include:

First, the CRS does not stipulate how quantitative targets, such as the annual amount of foreign exchange earnings which each local government is required to remit to the Centre, should be met. To fulfil the target, many local governments and the trading companies under their jurisdiction were inclined to increase export earnings by maximizing the volume of exports, rather than by improving the quality and upgrading commodity structure of exports, since it is easier to achieve the former than the latter. That is to say, during the reform period the growth of China's foreign exchange revenues still relied heavily on the increase in the quantities of exports, and this inevitably led to the downfalls of exporting prices and hence contributed to the deterioration of the trade terms for most Chinese exports in the international market. Table 3-2.6 shows that the indexes of export volume for the period of 1978-90 are persistently and substantially higher than the value indexes while the price indexes remain well below a hundred.[28] Thus, the old problem of the low efficiency of China's export transactions remains largely unsolved.

Further, the CRS, making the local government responsible for the implementation of the contract, has enhanced its powers and reinforced its tendency to interfere in enterprise's business operations, making the enterprise even

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[28]. Mr. Li Langqin, the minister of the MOFERT, has confirmed the seriousness of this problem. See Li langqin (1991).

more subservient to it (Chen Xin, 1989: 312).

Table 3-2.6 Indexes of value, volume and price of China's exports (1978 - 1990)

(1980 = 100)

	Value index	Volume index	Price index
1978	53.3	71.7	74.3
1979	74.7	87.1	85.8
1980	100.0	100.0	100.0
1981	114.3	110.9	103.1
1982	119.4	123.2	96.9
1983	121.5	140.6	86.4
1984	133.6	151.3	88.3
1985	141.8	172.5	82.2
1986	147.8	206.1	71.7
1987	189.9	249.5	76.1
1988	222.4	267.3	83.2
1989	237.7	266.5	89.2
1990	284.9	315.5	90.3

Source: The ACFERT Editorial Board (1991), p. 321.

Second, because of the semi-reformed nature of China's price, foreign exchange, tariff and taxation systems, differentiated rates of foreign exchange retention, tax, and cost targets for earning foreign exchange apply to different regions, sectors and trading companies. Failing to provide a level playing field for all companies, this discriminatory policy, coupled with the defects of the CRS mentioned above, have triggered off a spiral of fierce internal price competitions. Indeed, the "persistent trade wars" and hence the "ever increasing costs of export goods" has become the most serious problem in China's foreign trade reform in recent years (Zhao Tiecheng, 1989: 340-1).[29]

Third, China's primary and labour-intensive manufacturing sectors, though considered to be less urgent for technological upgrading, produced more than 70 percent of the country's exports (see Table 3-2.5), but most technology-intensive

[29]. For details of the "trade wars" among trading companies in Xiamen, see Chapter 7.

industrial sectors, considered to be more suitable and urgent for introducing advanced foreign technology, have found it hard to export their outputs. This means that under the current foreign exchange retention system the latter is in an extremely unfavourable position to obtain adequate foreign exchange to carry out technological innovations in comparison with the former, thus undermining the overall efficiency of the technological transformation in the Chinese industry.

With regard to imports, China has admitted that it spent too much foreign exchange in importing raw materials and left little for the introduction of advanced foreign technologies, know-hows and other software (Li Langqin, 1991).

And finally, the conflict between decentralized operation and irrational competition has not been settled yet (Zhou Xiaochuang, 1988). That is to say, the MOFERT, in light of the reform principle, gradually devolved business decision-making powers to various ministries, localities and even some key enterprises, but this immediately leads to the fierce internal price competitions, despite a decade of the reform.

CHAPTER 4

CHINA'S UTILIZATION OF FOREIGN CAPITAL AND DEVELOPMENT OF THE SPECIAL ECONOMIC ZONES

Apart from vigorously reforming its old, centralized industrial and foreign trade systems, China has also actively carried out two unprecedented missions in the foreign economic front --- utilizing foreign capital and developing the SEZs. In fact, these two new tasks are the clearest indication of China's determination to break with its past foreign economic policy.

For nearly three decades since its founding in 1949, the PRC has rejected any inflow of foreign capital (except for minor amounts of Soviet aids in the early 1950s) and the government, bound by its old doctrine of Self-Reliance, had in fact been proud of having no internal and external debt. Over the past twelve years (1979-90), however, the world has witnessed a dramatic change in the Chinese foreign economic scene. Today, foreign capital is no longer seen as "*evil*," but as a "necessary and beneficial *complement* to China's socialist economy" (Central Committee, 1984). By the end of 1990, China had signed some 29,693 contracts on the use of foreign funds involving a total amount of US$1,020 million, of which US$680.75 million had actually been used (see Table 4-1.1). At the same time, the five SEZs, Shenzhen, Zhuhai, Shantou, Xiamen and Hainan, have now become the nation's focus of foreign investment and centre of rapidly expanding industrial exports. Thus, a new dimension of reform and development in a centrally planned economy has been created.

The purpose of this chapter is, therefore, to examine this new development in China's foreign economic sector. Section 4-1 investigates the Chinese official policy,

performance record, and problems and issues regarding the utilization of foreign capital, especially FDI; Section 4-2 examines the development of the first four SEZs, and Section 4-3 surveys the Xiamen SEZ in greater detail in order to provide a solid historical and contextual background for the more systematic analyses in the following chapters.

4-1. The Utilization of Foreign Capital[1]

4-1-1. Objectives and Principles

Since the beginning of the present reform and openness, China has consistently declared that it would make use of foreign capital to accelerate its modernization programme. Foreign capital is expected to *supplement* domestic resources in the process of economic and technological transformation. Thus, the main objectives for China to use foreign capital may be summarized as follows:

First, it is to compensate for the shortage of capital caused by modernization programmes, especially to meet the huge investment demands created by the construction of infrastructures and public utilities.

Second, it is to be used as an effective means to obtain advanced foreign technology, equipment, management expertise (especially in modern, large-scale specialized production), and international marketing skills in order to improve economic performance in existing Chinese enterprises.

Third, it is to generate foreign exchange to enable China to make further imports and carry out more surveys on the overseas market.

Thus, the principles guiding the use of foreign capital, though subject to changes and adjustments from time to time,

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[1]. For a general discussion of China's utilization of foreign capital, see Ho (1984); Huan Guocang (1986); Liu Guoguang, *et al.* eds. (1987a), Chapter 23; Riskin (1987), Chapter 13; Robinson (1987); UNCTC (1988); Kojima (1988); the State Council Research Group (SCRG) (1992); and JEC (1992), Chapter V.

include the following four points:

First, the main emphasis is to be put on attracting FDI, particularly, Sino-foreign joint equity ventures (JEVs) and wholly foreign-owned enterprises (WFOEs). There are at least four reasons for this preference: 1). in the case of JEVs and WFOEs, China generally assumes little or no responsibility for the risk with foreign investors; 2). the Chinese believe that foreign investors, especially in the case of JEVs, will not only contribute capital but also bring with them technology and managerial skills in order to make the investment successful; 3). some of FDI projects may provide China with an unique chance to open up its international market; and 4). many forms of FDI can also make use of existing production capacities and facilities.

Second, the seventh FYP gives the first priority of foreign investment to such infrastructures as energy, transport, telecommunication, raw and semi-finished materials, and technological renovation of machinery and electronics industries.

Third, while making more efforts to attract FDI, China has also stressed the need to diversify its channels of obtaining foreign funds, especially to maximize the use of official development aids and the loans provided by foreign governments and international financial institutions, such as the World Bank, IMF and the Asian Development Bank, to finance large projects characterized by long gestation period, low profit return, and poor foreign exchange repayment capacity.

And finally, the scale of foreign capital attracted should be limited by the domestic capacity to absorb and supplement it. It is generally believed in China that it is appropriate to maintain the Debt Service Ratio (DSR) under 15 percent, 5 percent lower than the internationally accepted warning line (*RMRBh*, 30/4/1987: 1)[2].

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[2]. DSR is the ration of the annual repayment amount of currently due interest and principal (in terms of foreign exchange) to the annual revenues of exports (in terms of foreign exchange). It is widely regarded as an chief indicator to measure the appropriateness of the scale of foreign capital

4-1-2. Performance Records

China started introducing foreign capital soon after the historic Third Plenum in December 1978, indicated by the promulgation of the first ever law concerning the use of foreign capital since 1949 --- *the Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Capital* --- in July 1979 (see Appendix C). Table 4-1.1, showing the general achievement over the period of 1979-90, reveals a rapid, though with

Table 4-1.1 China's utilization of foreign capital (1979 - 90)

(US$100 million)

	Total		Foreign loans		FDI		Others	
Year	Item	Value	Item	Value	Item	Value	Item	Value
Contracted								
1979-82	949	205.48	27	135.49	992	60.10		9.89
1983	522	34.30	52	15.13	470	17.32		1.85
1984	1,894	47.91	38	19.16	1,856	26.51		2.24
1985	3,145	98.67	72	35.34	3,073	59.31		4.02
1986	1,551	117.37	53	84.07	1,498	28.34		4.96
1987	2,289	121.36	56	78.17	2,233	37.09		6.01
1988	6,063	160.04	118	98.13	5,945	52.97		8.94
1989	5,909	114.79	130	51.85	5,779	56.00		6.94
1990	7,371	120.86	98	50.99	7,273	65.96		3.90
1979-90	29,693	1,020.78	644	568.33	29,049	403.60		48.85
Used								
1979-82	------	124.57	---	106.90	------	11.66		6.01
1983	------	19.81	---	10.65	------	6.36		2.80
1984	------	27.05	---	12.86	------	12.58		1.61
1985	------	46.47	---	26.88	------	16.61		2.98
1986	------	72.58	---	50.14	------	18.74		3.70
1987	------	84.52	---	58.05	------	23.14		3.33
1988	------	102.26	---	64.87	------	31.93		5.46
1989	------	100.59	---	62.86	------	33.93		3.81
1990	------	102.89	---	65.35	------	34.87		2.68
1979-90	------	680.75	---	458.55	------	189.82		32.38
Used (%)	------	66.69	---	80.68	------	47.03		66.28

Source: SSB (1991), p. 629.

fluctuations, expansion in terms of both contracted and used amounts. For example, the total number of projects and amount

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a nation borrows.

of capital attracted in 1990 are more than 14 times and 3.5 times of the corresponding figures for 1983, with an average annual growth rate of 45.97 percent and 19.66 percent respectively. Indeed, China's introduction of foreign capital over the decade of the 1980s had exceeded the records of all other Asian countries/regions. In terms of average annual inflow of FDI, China even outperformed Brazil and Mexico, the two developing countries which had attracted most of foreign investment in the 1980s. Also, the ratio of the used amount of FDI to the total used amount of foreign funds (27.88%) is one of the highest in developing countries (SCRG, 1992: 6-7).

As this thesis deals mainly with FDI in the Xiamen SEZ the following discussions will therefore focus on FDI only. In general, there are several important features to be noted in China's utilization of FDI over the period of 1979-90:

First, Hong Kong and Macau have always been the largest investor, accounting on average for 61.6 percent, with the U.S.A. numbering the second (8.42%) and Japan the third (5.47%). Since the late 1980s, Taiwan has emerged as an increasingly important investor in the PRC (ibid: 6).

Second, in terms of industrial structure of investment, the share of so-called "productive sectors" (including the primary and secondary sectors) increased steadily, from 45.04 percent in the period of 1979-88 to 86.28 percent in 1990, while the share for the "non-productive sector" (i.e. the tertiary sector) declined firmly, from 54.96 percent to 13.72 percent. Among the "productive sectors," the share for those manufacturing/processing/assembling light industrial and consumer goods dropped markedly, from 75.87 percent in the period of 1979-87 to 69.74 percent in 1990, while the share for basic industrial sectors and infrastructures rose noticeably, from 24.13 percent to 30.26 percent (ibid: 8).

Third, with respect to the form of investment, JEVs has become increasingly popular, with their share in the total FDI invested amount increasing remarkably, from 42.33 percent in the period of 1979-83 to 54.09 percent in 1990. WFOEs also expanded rapidly, moving up from just over 3 percent in the

period of 1979-82 to the staggering 21.1 percent in 1990. Contractual management enterprises (CMEs) seemed to lose ground steadily, dropping from 78.7 percent in the period of 1979-82 to 19.33 percent in 1990 (ibid: 10; ACFERT Editorial Board, 1984: 1092; 1991: 49).

Fourth, FDI has been concentrated mainly on the eastern and southeastern coastal areas, where most of China's SEZs, ETDZs and a variety of open areas are located. For example, in 1990 Guangdong, Fujian and Liaoning provinces and Shanghai municipality were the four largest recipients of FDI, taking 40.78, 17.61, 7.49 and 5.68 percent, respectively, of US$6.596 billion of the nation's total FDI contracted amount in that year (ibid: 586-7).

And finally, the introduction of FDI has greatly promoted the rapid development of China's export manufacturing capacity. Exports from foreign-involved enterprises (FIEs) in China increased sharply[3], from US$ 320 million in 1985 to US$ 6.021 billion in 1990, with an average annual growth rate of 79.85 percent --- far exceeding 14.97 percent for the total national exports over the same period. At the same time, their share in the country's total exports jumped from one percent in 1985 to 11.56 percent in 1990 (*BR*, Mar. 6-12, 89: 25; ACFERT Editorial Board, 1991: 50).

4-1-3. Problems and Issues

Although the rapid expansion of FDI projects in recent years has widely been regarded as the most successful achievement of the "open-door" policy, several serious problems still exist in China's utilization of FDI.

First, the central problem faced by China has been the lack of domestic inputs to supplement foreign capital, and this problem has become the "bottleneck" to the further introduction of FDI. The shortage of domestic supplemental cash (including RMB and foreign exchange) was particularly

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[3]. FIEs (*Waizi Qiye*) in China generally include JEVs, CMEs and WFOEs.

acute.[4] Despite the fact that the RMB loans to FIEs in 1990 increased by 110 percent over 1988, many of them still had to suspend or even scrap their operations due to the lack of adequate funds. Besides, the shortage of power supply, transport and communication facilities, raw materials, and competent managerial personnel has also hindered the further expansion of FDI. Some regions had to cut back those supplies to local Chinese enterprises in order to secure the normal operation of FIEs (SCRG, 1992: 7-8).

Second, the sectoral structure of FDI did not match the priority and plan of China's industrial transformation. This can be reflected primarily in three aspects: 1). as high as 31.64 percent of FDI contracted amount over the period of 1979-1988 went to non-productive areas, such as hotel, leisure and entertainment centre, and real estate business; 2). nearly three-quarters of that amount was invested in lower-end labour-intensive sectors, such as textiles, building and decorative materials, food processing and electronics assembling, with few Chinese domestic components; and 3). the scale of investment became smaller and smaller, dropping sharply from US$3.53 million per project in the period of 1979-87 to US$1.29 million per project in 1990. According to the Chinese standard, 99.4 percent of all FDI projects in China in 1990 can be classified as small-scale enterprises and only 0.6 percent as medium- and large-scale ones (ibid: 8-10).

Third, the Chinese authorities have apparently failed to work out a long-term plan for utilizing FDI, which is based on detailed analyses of the domestic needs and the dynamics of the world economy. In other words, they have failed to integrate FDI into the national economic development plan. As a result, instead of "seeking money for projects," they often were "seeking projects after getting money" (Liu Guoguang *et al.*, 1987a: 510). Needless to say, the economic efficiency of such projects tends to be very low.

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[4]. It is estimated that for every one US dollar of foreign investment eight or nine Yuan will be needed as supplemental funds (SCRG, 1992: 7).

Fourth, the Chinese authorities often used "foreign exchange earning capability" as the chief criterion in assessing the viability of FDI projects, instead of "the overall and long-term interest of the national economy." As a result, many projects which either are beneficial to the all-round development of the national economy or have a long-term potential of earning foreign exchange, have been turned down simply because they may increase foreign exchange expenditure either in a particular sector/enterprise or for a short period of time (Huan Jianping, 1988: 38).

And finally, FDI development in China has been very vulnerable to the Chinese domestic economic boom-bust cycle[5]. This is particularly true when the austerity policy is imposed nationwide in order to cool off the overheated economy. Many FIEs have to curtail, suspend or even cancel their operations altogether because of the abrupt stoppage or cutback of the Chinese input supplies and/or the imposition of tight monetary policy. For example, the retrenchment policies implemented in the late 1985 and the period of 1988-89 have led to various degrees of declines in the number of FDI contracts signed (indeed the total size of foreign capital inflow as well) in 1986 and 1989 (see Table 4-1.1).[6]

4-2. The Development of the Special Economic Zones

In order to accelerate the progress and increase the effects of the "open-door" policy, the Chinese government, tempted by the success of the EPZs in neighbouring countries /regions, decided to set up four similar zones in China's

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[5]. Lin Shenmu and Xu Li (1986) argues that FDI in China is far more sensitive to Chinese domestic economic changes than to the world's economic waves and hence concludes that most of the variables affecting the utilization of FDI in China are "endogenous." See Lin and Xu (1986), p. 15.

[6]. Of course, the reduction in foreign capital inflow into China in 1989 can also be attributed to the sanction imposed by many Western governments in the aftermath of the Tiananmen Square Incident.

southeastern coastal areas in the early 1980s and one in the Hainan Island in 1988. As these zones are generally more comprehensive and expected to have a greater role to play in the Chinese economy than EPZs, they are called as Special Economic Zones. Obviously, to build up an enclave economy significantly incompatible with the host economy on such large scale is unprecedented in socialist countries. The SEZs could therefore be seen as the *microcosm* of China's effort to develop a capitalist-style economy.[7]

After successive expansions of their territories, the first four SEZs now have a total area of 526.26 sq km, with Shenzhen having 327.5 sq km, Shantou 52.6 sq km, Zhuhai 15.16 sq km, and Xiamen sq 131 km. The fifth one, the Hainan Island, with an area of 34,000 sq km, is undoubtedly the largest zone of its kind not only in China but also in the world.

Thus, the SEZs, together with fourteen Open Coastal Cities (OCCs),[8] three Economic Development Zones (EDZs)[9] and all areas along China's eastern and southeastern coastline,[10] form four tiers of China's open areas (see Figure 4-2.1). In all, these areas cover about 300,000 sq km, with a population of around 200 millions.

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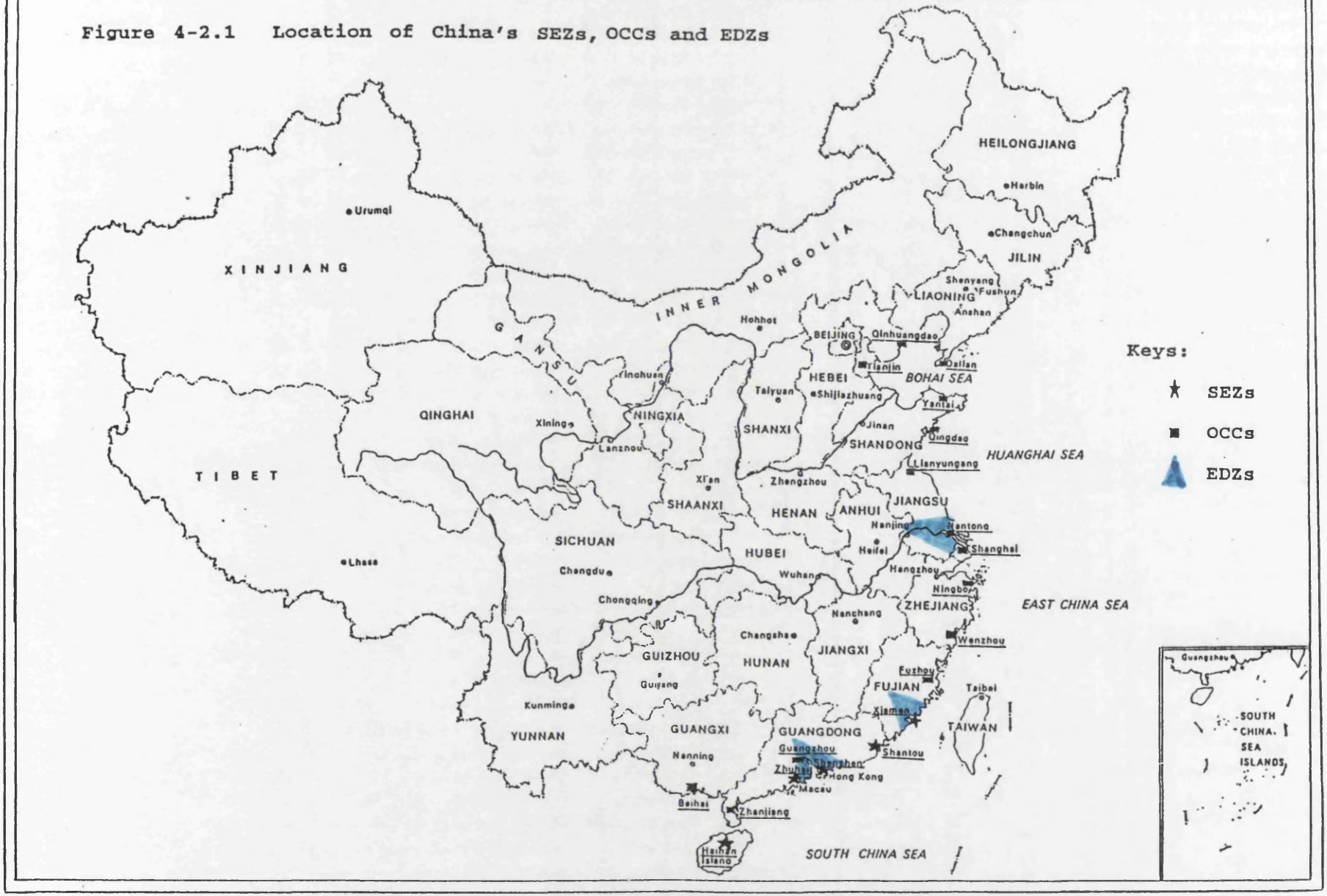
[7]. For excellent English-language publications on the SEZs at different stages, see Footnote 1 in Chapter 1, while for the Chinese-language analyses, see chiefly Liu Guoguang (1985) and (1987b).

[8]. They are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhangjiang and Beihai. Opened in April 1984, they are encouraged to increase their foreign economic activities chiefly through setting up Economic and Technological Development Zones (ETDZs).

[9]. They are the Yangtze River Delta, the Pearl River Delta and the Southern Fujian Triangle. Set up in January 1985, they are encouraged to develop agricultural export resources.

[10]. They were declared as Open Areas in February 1988.

Figure 4-2.1 Location of China's SEZs, OCCs and EDZs



4-2-1. Functions of the SEZs and the Special Policy

The purposes of setting up the SEZs are to expedite the expansion of exports and the introduction of foreign capital, technology and management expertise; and to experiment some radical economic reforms in these areas. The last function implies that the SEZs are to act as a "laboratory" for the ongoing domestic economic reform and "open-door." Of course, the SEZs can also serve the political purpose of reflecting China's foreign policy towards Hong Kong, Macau and Taiwan.

Deng Xiaoping, the Chinese paramount leader, summarized the functions of the SEZs as "four windows," i.e. the SEZs are China's windows of technology, management, knowledge and foreign policy (Chen Zaobin, 1986). The Chinese government expected the development of the SEZs to exhibit "four characteristics." They include: 1). the economic development of the SEZs should be powered mainly by foreign capital; 2). SEZ outputs should, in principle, be exported; 3). FIEs should become the mainstay of SEZ industry; and 4). SEZ economy should be regulated primarily by market forces.

To provide a business environment different from that existing in the rest of the country, the Chinese government has allowed a special policy (*Teshu Zhengce*), or "flexible policies" (*Linghuo Zhengce*), to be implemented in the SEZs. According to Mr. Lu Zufa, a Deputy Secretary-General of the Shenzhen SEZ Government, the Special Policy means economic policies and management systems in the SEZs can be different from those implemented elsewhere in the country (Lu, 1987: 140). It includes a package of financial concessions, administrative and legal simplifications offered by the Chinese authorities to foreign investors, and, more significantly, the special privilege granted to the SEZs to carry out radical economic reform without being subject to the restriction applied to elsewhere.

The financial concessions in the SEZs are basically similar to those found in EPZs or EPZ-type economic zones

worldwide[11]. However, the special reform privilege is definitely unique to the SEZs. It is crucial to the development of the SEZs because "only a radical economic reform can bring vitality, flexibility and potential to the SEZs," as argued by Mr. Li Hao, the former mayor of Shenzhen (Li Hao, 1986: 86).

4-2-2. Performance Records[12]

It must be pointed out that data regarding the performance of the SEZs are normally scattered, incomplete and sometimes self-conflicting. Hence, adequate cautions should be exercised in both using and understanding them. Table 4-2.1 shows a generally increasing trend in several major indicators for China's first four SEZs, although three indicators (national income per capita, exports, and number of contracts of introducing foreign capital) started levelling off or even declining in the period of 1989-90. In particular, the average annual growth rates for all indicators are much higher than the national rates. For example, the national income per capita for the SEZs grow by 22.47 percent per annum between 1980 and 1989, GVIO by 30.18 percent between 1980 and 1990, exports by 26.07 percent between 1982 and 1990, and invested amount of foreign capital by 10.26 percent between 1986 and 1990, compared with only 13.53 percent, 12.64 percent, 11.13 percent, and 9.10 percent, respectively, for China as a whole over the same periods.

The most prominent achievement for the SEZs, however, has been the rapid expansion of manufactured exports. In 1990, more than 60 percent of exports from Shenzhen and Shantou were manufactured goods, while exports of radio cassette, colour TV

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[11]. For more details about the concessions, best see MOFERT (1983); China International Economic Consultants Inc (1984); and Chu Baotai (1986).

[12]. In order to make data comparable, the Hainan SEZ, set up only in 1988, is not included in the discussion of this section.

sets and bicycles from Shenzhen and Xiamen accounted for more than half of the nation's total exports of those products (He Chunlin, 1991: 6).

Table 4-2.1 Performances of the first four SEZs (1980-90)

	1980	1982	1984	1986	1988	1989	1990
National income per capita (¥)	801	1,055	1,968	2,676	4,969	4,967	----
% of national total (%)	213.12	249.99	361.14	363.11	466.16	421.68	----
GVIO (in 1980 prices, ¥ b.)	1.93	2.30	4.22	7.54	17.33	22.31	26.92
% of national total (%)	0.28	0.30	0.42	0.56	0.90	1.07	1.19
Exports (US$ million)	----	710	830	1,845	4,109	7,041	4,530
% of national total (%)	----	3.18	3.18	5.96	8.65	13.40	8.72
No. of contracts of introducing foreign capital	----	----	----	1,347	1,516	1,368	----
% of national total (%)	----	----	----	86.85	25.00	23.15	----
Contracted amount (US$ million)	----	----	----	669	1,110	1,454	----
% of national total (%)	----	----	----	5.70	6.93	12.67	----
Invested amount (US$ million)	----	----	----	654	861	960	967
% of national total (%)	----	----	----	9.01	8.42	9.54	9.40

Sources: a). 1980-89: He Chunlin, ed. (1991), pp. 525-32;
b). 1990: The ACFERT Editorial Board (1991), p. 84, but excluding the amounts for the Hainan SEZ.

In the meantime, the SEZs, Shenzhen in particular, have carried out a series of economic reforms. Tangible changes have taken place in planning, financial, monetary, investment, foreign trade, employment, and wage systems (*RMRBh*, 5/4/89: 3). These include independent planing (*Jihua Danglie*), allowing foreign banks to set up branches in the SEZs, adopting a public bidding for carrying out capital constructions and replacing state investment funds with bank loans, introducing a contract system in the employment of

workers and a public advertising or democratic election system for the appointment of some senior personnel, practising a floating wage system, and, more recently, selling land rights to public or private (including foreign) institutions or individuals. Some of these experiments have been transplanted to some parts of the country. Furthermore, factor markets, such as capital, labour, producer goods, and foreign exchange markets, have been established, while those for technology, information and property were also emerging (*RMRBh*, 5/4/89: 3).

Another important development in the SEZs has been the rapid growth of HEAs, which are different from those found in elsewhere of China due to the Special Policy implemented in the SEZs. They are either inward-linked (*Neilian Qiye*) or both inward- and outward-linked enterprises (*Neilian Waiyin Qiye*). In the former case, they are generally formed between local enterprise(s) and interior partner(s). In this way, the interior enterprise(s) can take advantage of the Special Policy to export their products (and retain more foreign exchange earnings) and import some scarce or restrictive foreign goods; while zone partner(s) can get the technical assistance and supply of some crucial raw materials from the interior. By 1990, for example, about 40 central ministries/commissions and 29 provinces/municipalities/ autonomous regions had set up some 3,900 inward-linked enterprises in Shenzhen, financing 15.9 percent of capital constructions, supplying 60 percent of physical resources and 600 thousands of labour forces, and contributing 17.4 percent of the SEZ's GVIO. At the same time, Xiamen had established 1,090 similar enterprises and received funds of ¥770 million from interior partners (He Chunlin, 1991: 7-8).

In the latter case, the associations are usually composed of three sides, interior, local and foreign partners. Hence, they are in fact FIEs. By the end of 1989, about 3,300 FIEs had been set up in the SEZs, exporting more than 80 percent of their products. They had contributed more than 60 percent of GVIO for Shenzhen and Shantou, 41 percent for Xiamen, and 25

percent for Zhuhai. Around 20 percent of their projects are considered to be in the advanced level in their fields (ibid: 7). Thus, the HEAs in the SEZs, as a major mechanism to promote linkages between the interior China and the SEZs and between China and the outside world, have created profound impacts on the development of the SEZs and indeed China's industrial transformation.

4-2-3. Problems and Issues

Many people, especially Chinese officials, praise the SEZs by referring to the "miracle" achieved by them, Shenzhen in particular. However, they neglect an important factor behind the phenomenal success --- the huge cost incurred by the national economy in supporting the development of those small areas. Unfortunately, a formal cost-benefit analysis of the SEZs is impossible because of the unavailability of data regarding the factor movement between the SEZs and interior regions. Furthermore, in many cases, the gains or costs of the SEZs are not exclusively of economic nature and hence are intrinsically immeasurable[13]. Nonetheless, the opportunity costs can still be indicated partly by the increasingly generous financial concessions offered to foreign investors; and partly by the fact that the SEZs are guaranteed to get almost any inputs they need at favourable terms.[14] Indeed, many interior enterprises have offered their most advanced technologies/products and/or most competent personnel to zone partners as a condition of forming HEAs with them. All this has explained why the SEZs could manage to achieve the spectacular development in a relatively short period of time.

Several serious problems and issues have emerged from the

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[13]. For more comments on this issue, see Richard D. Robinson (1987), pp. 169-71; Joseph Battat (1987), pp. 156-7; Liu Guoguang, *et al.* eds (1987a), p. 497; and Pu Shan (1987), p. 178.

[14]. For example, Shenzhen and Xiamen enjoy a provincial status in arranging their annual physical, financial and human resource plans (*Jihua Danlie*).

process of development and may be highlighted as follows:

1. *Irrational Investment Structure* Despite a marked improvement in recent years, FDI projects in the SEZs are still dominated by the characterized by quick and high returns and low risk, such as real estate, leisure facilities, hotel and tourism. This kind of projects, still accounting for nearly 30 percent of the total FDI projects in 1989 (Chen and He, 1989: 10), bears little congruence with the long-term goal of China's industrial development.

On the other hand, due to social, economic and geographic reasons the SEZs generally have far higher concentration of investments from Hong Kong, Macau, Taiwan, and Southeast Asian countries. These investment projects, accounting for as high as 90 percent of the total FDI projects in the late 1980s and early 1990s, are largely confined to small- and medium-sized labour-intensive projects, with an average capitalization of less than HK$840,000 per project (ibid: 9).

2. *Poor Performance in Technology Transfer* As described above, most of FDI projects in the SEZs are small-sized labour-intensive ones manufacturing light industrial or consumer goods and hence tend to have very low ratios of capital/technology:labour. Some foreign investors, especially the Taiwanese, even use some traditional methods and a large number of second-handed equipment, maximizing the utilization of local cheap labour forces. During the decade of 1980s, the SEZs spent as high as 65 percent of their budget on importing complete set of equipment, 20 percent on joint development, and only 15 percent on license, lease and franchise arrangements (Chen and He, 1989: 10). What is more, the SEZs have failed to study systematically and hence make full use of most of imported technologies (*China Market*, 2/89: 32), let alone to modify and adapt them into the local conditions.

3. *Balance of Payment Problem in FIEs* About 63 percent of FIEs in the SEZs have various degrees of balance of payment problem because, having imported a large quantity of raw materials and equipment, they failed to export adequate amount of their finished products (SCRG, 1992: 12). A dozen of them,

for example, went bankrupt between 1986 and 1988 (He Jiashen *et al.*, 1988). As a result of this problem, foreign exchange debts for FIEs in 1987, 1988 and 1989 accounted for 29.7 percent, 32.4 percent and 35.6 percent, respectively, of the foreign exchange earnings for all FIEs in the SEZs in the three years (ibid). Without doubt, this poor performance will seriously undermine foreign investors' confidence in investing in the SEZs.

4. *Problems in Administration and Infrastructures* All the four SEZs, except Xiamen, are situated in remote rural and border areas[15]. Although enormous efforts have been made to build and improve the physical, administrative and legal environments in the zones, there is still a long way to go before they become acceptable. What foreign businesses have complained most seems to be the low efficiency of administration, caused by bureaucratic bungling and/or incompetence of local officials, and the high investment costs resulting from inflation and imposition of a variety of unreasonable charges. In addition, inadequate legislation, ambiguous attitude towards contracts, unpredictable political climate, poor quality of local inputs have all contributed to deter foreign investors from making further investment in the SEZs.

5. *Widespread Malpractice and Corruptions* The SEZs have long been accused of being a "breeding ground" for official corruptions in China. Incidents involving briberies, speculations in foreign exchange and property business, inside dealings in stock markets, smuggling, and tax evasions have been reported frequently in the Chinese media and press.

There are numerous reasons for the above problems. Two important relationships seem to be crucial to the understanding of them. The first one is the conflict between China's wish to develop technology-intensive industries and

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[15]. This is also due to the Chinese leadership's intention to minimize the "negative effects" of market-oriented economy in the SEZs on the domestic economy.

foreign businesses' intention to set up labour-intensive projects (in order to maximize the use of the Chinese cheap labours). In fact, this conflict has created a dilemma for China of choosing either the quality or quantity of FDI.

The second one is the structural conflict between China's wish to export all, or a large part, of SEZ outputs and foreign businesses' interest in opening up the Chinese domestic market (potentially the largest one in the world). Similarly, this conflict has also resulted in a dilemma for China of either exposing infant and inefficient domestic industries to foreign competition or undermining the attractiveness of investing in the SEZs.

In the final analysis, the development of the SEZs over the last decade or so could be seen, at best, as a local success, which has been achieved at a huge cost to the national economy, when one considers the massive and endless influx of financial, physical and human resources from all over the country into those small areas ever since they were set up. At the same time, they have often been used by the different factions within the Chinese leadership to serve their *political*, instead of *economic*, purposes.[16] The multiple objectives they have been asked to pursue are in fact a mixture of political and economic goals and often contradictory to each other. As introduced in Chapter 1, an EPZ-type zone should be set only *one* prime objective, and any contributions it makes to other objectives should be regarded as desirable externalities. The Chinese government has apparently failed to realize the interactions among various objectives. Instead, it put equal stress on all of them and pursued them indiscriminately. The result is that none of the objectives has been clearly achieved.

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[16]. For more details of SEZ politics, see Crane (1992), pp 851-7.

4-3. The Xiamen SEZ[17]

Located on the southeastern coastal area of China (118°04'04''E longitude and 24°26'46''N latitude), the Xiamen Municipality (*Shi*) is backed by a hinterland, borders on Zhangzhou and Quanzhou two municipalities, and faces Taiwan across the Taiwan (Formosa) Straits (see Figure 4-2.1). It consists of the Xiamen Island, Gulangyu Islet and the coastal part of the northern bank of the Jiulongjiang River, with a total area of 1,516 sq km. The Gaoji Causeway built in 1955 connects the Xiamen Island with the mainland (see Figure 4-3.1).

Xiamen is under the jurisdiction of Fujian province and composed of six districts (*Kaiyuan, Siming, Gulangyu, Huli, Jimei* and *Xinglin*) and one county (*Tong'an*). It had a population of 1.12 million at the end of 1990, of which 60 percent were classified as urban residents.

Xiamen lies just north of the Tropic of Cancer, enjoying the southern, sub-tropical monsoon climate. It is mild and rich in rainfall, with an annual mean temperature of 20.8°C and precipitation of 1,200 mm. Typhoon normally takes place 5 or 6 times each year.

In July 1980, the State Council approved the proposal presented by the Fujian Provincial Government to open up an area of 2.5 sq km in the Huli District, situated in the northwestern Xiamen Island, as *the Xiamen SEZ*.[18] In March 1984, the central government decided to expand the Xiamen SEZ into the whole Xiamen Island (including the Gulangyu Islet), with a total area of 131 sq km (blue-coloured area in Figure 4-3.1) and population of 360,000.

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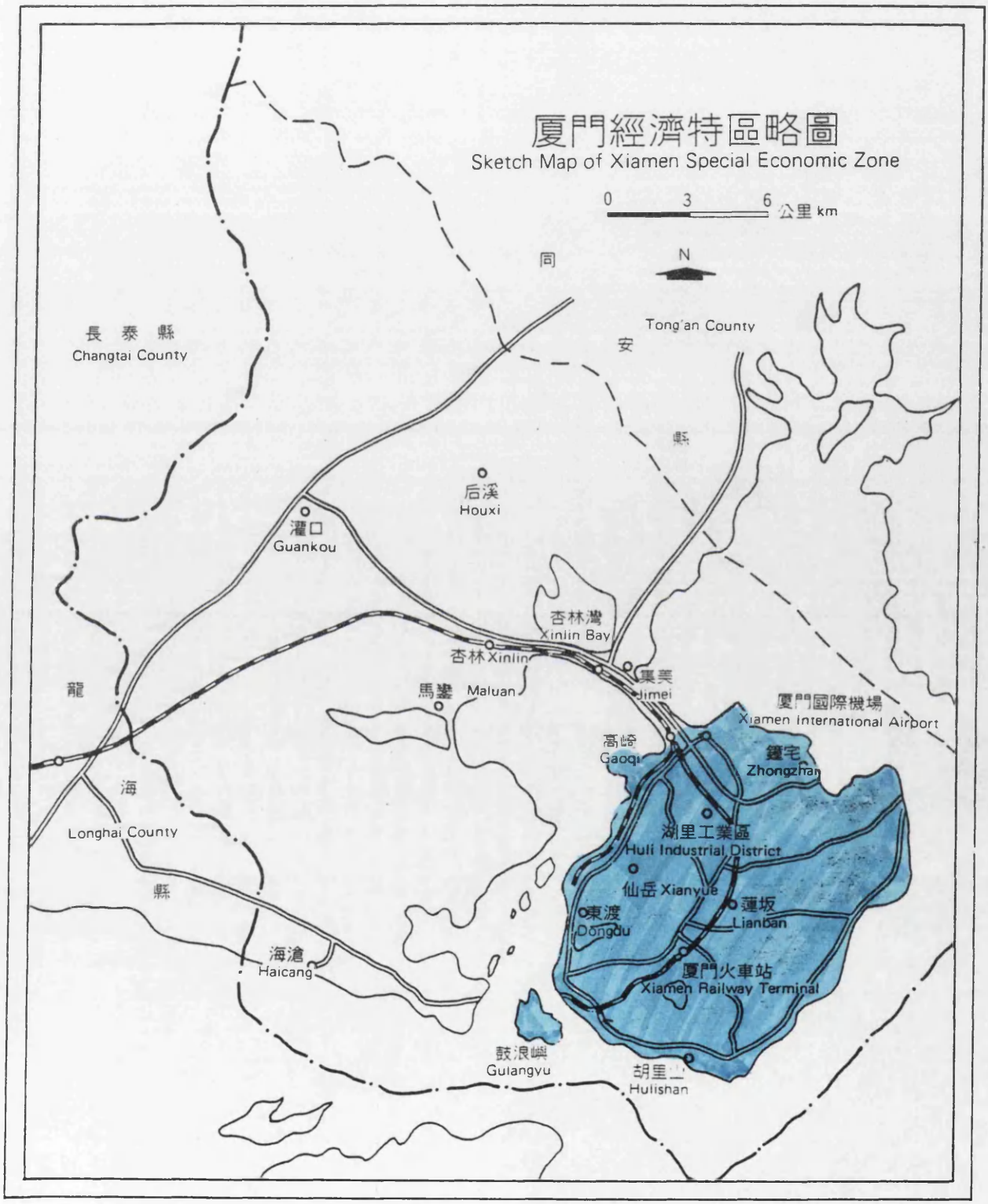
[17]. This section draws extensively on the Research Office (1989), pp. 16-25. The data and facts cited here are, unless specified otherwise, extracted from it.

[18]. However, the formal construction of the SEZ did not start until October 1981.

Figure 4-3. 1 The Sketch Map of the Xiamen SEZ



4-3-1. The Economy before 1949

A Treaty Port

Acting as a link between the rich Yangtze floodplain and the Pearl River delta and serving as a bridge between mainland China and Taiwan, Xiamen became a major seaport in Southeast China as early as the 16th century. Not surprisingly, Xiamen, together with Tianjing, Shanghai, Ningbo, and Guangzhou (Canton), was designated as a *Treaty Port* in November 1843, according to the *Nanking Treaty* signed between the Chinese and British governments after the Opium War.

In fact, the rise and continual development of the Xiamen economy was closely linked to overseas trade. In 1844, the British Plenipotentiary in China, Sir John Francis Davis (1795-1890), visited Xiamen while touring south China and described it as an "old European port." He noticed that "the natives there are familiar with foreigners, and not only trade with, but emigrate in great number to the colonies of the Indian archipelago" (Davis, 1852, vol.1). In his report to the British government, Davis reckoned that Xiamen, together with Shanghai, had a great potential to become a thriving trading port in the Far East. Indeed, Xiamen soon witnessed a boom of its foreign trade with the West. The total volume of exports and imports soared from 93,262 taels in 1844 to 6,5 million taels in 1870.

The opening of the treaty port and the subsequent expansion of external trade had attracted many European merchant ships to call on the Xiamen coast frequently and induced inflow of 20 foreign banks, including the Standard Chartered Bank (U.K.), the Hong Kong-Shanghai Banking Corporation (U.K.), and the Overseas-Chinese Banking Corporation Ltd. (Singapore), making Xiamen the foreign trade and financial centre in Southeast China (see Figure 4-3.2).[19]

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[19]. Even today this number of foreign bank has not been exceeded (only reached 11 at the end of 1990).

Figure 4-3.2 The Amoy Harbour in the second-half of the 19th century (source unclear)

Amoy, from the Outer Anchorage.

Close Links with Taiwan and Overseas Chinese

Xiamen has a close historical, political, social, economic, and lineage ties with Taiwan. When Taiwan was first incorporated into China in 1683, it was under the same administrative jurisdiction of the Fujian government and the command of Taixia Military District as Xiamen was. Since Taiwan became a separate province in 1728, Xiamen had been the only authorized seaport in the mainland open to Taiwan for over a century, playing a crucial role in maintaining and developing the mainland-Taiwan link.

From the 16th century, many mainland merchants, mostly from southern Fujian, started trading with Taiwan. The distance between Xiamen and the ports in the western Taiwan ranges from 130 to 150 nautical miles. For centuries, the merchants travelled between the two sides of the Straits, exporting such products as tea, ceramics, cloth, silk and sugar to Taiwan and importing goods like spices, pepper, precious metals and rice, etc. to the mainland. At its peak, the trading involved 1,500 merchant ships each year.

In 1662, tens of thousands of Chinese troops, led by Zheng Chengong, invaded Taiwan to expel the Dutch colonists. After defeating the Dutch, many soldiers, especially those from southern Fujian, did not return to the mainland but settled down in Taiwan. They joined the native Gaoshan Nationality, to exploit and develop Taiwan generation by generation. Today, about 70 percent of the Taiwanese population are Southern Fujianese (*Min Nan Ren*) by origin. On the other hand, about 30 percent of Southern Fujianese have relations in Taiwan. Thus it is not surprisingly that Taiwanese and Southern Fujianese speak the same dialect (*Min Nan Hua*), share the same customs, and feel intimate toward each other.

Without doubt, these factors explain why the resumption and indeed expansion of the economic and trade links between the two sides in 1980s have developed so smoothly and rapidly.

At the same time, Xiamen is also a major hometown of many

overseas Chinese. It was estimated that more than four million overseas Chinese --- roughly one-fifth of the world's total overseas Chinese population --- have roots in Xiamen and the neighbouring southern Fujian regions (Li Si-ming and Zhao Ling-xun, 1992: 235).[20] For centuries, they have played a crucial role in Xiamen's development, especially in the first half of the twentieth century. The earlier emigrants from Xiamen were largely merchants and went abroad to develop their trading businesses. Later, especially after the Opium War, more and more people went abroad and worked as coolies, mostly in Southeast Asia and America. During the 1840s and 1850s an average of 50,000 workers a year were sent abroad, with the number exceeding 100,000 in some years (ibid: 226).

The most visible and important contributions made by overseas Chinese to Xiamen has been the huge and sustained inflow of foreign exchange remittance sent back to Xiamen and the large-scale direct investment they made in infrastructures, public utilities, and real estate in Xiamen. In 1913, the Xiamen Customs Commissioner, J. H. Hacoun, estimated in his *Ten-Years Report (1902 - 1911)* that the remittance reached 16-18 million taels each year, and that about 80 percent of the families in and around Xiamen were supported at least partly by the remittance.

At the same time, the Zhang-Xia railway, the Xiamen Light and Power Company, the Xiamen Waterworks Supply Company, the Xiamen Bus Company, the Xiamen Telephone Company, and many modern buildings, high streets and parks in the downtown areas were all built by the overseas Chinese. It was estimated that up to 70 percent of the investments in public utilities and real estate during that period came from them (ibid: 227).

The overseas Chinese also pioneered the development of Xiamen's modern manufacturing industries, commerce, and financial services. For example, the first food and canning factory, the ceramic plant, the electric appliance factory, the glassware workshop, the textile mill, the department

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[20]. Another account actually puts this figure as high as over 6 million, see Wong Pui-Yee (1989), page 30.

store, and the bank were all set up by the overseas Chinese.

It was estimated that the total number of the various enterprises founded by the overseas Chinese in Xiamen during the first half of this century was 2,658, involving total capital of ¥87.48 million, which accounts for 62.88 percent of the total direct investment by the overseas Chinese in Fujian over the same period.

By the late 1940s when the Nationalist government collapsed in the mainland, Xiamen had already developed into a bustling commercial seaport, with a population of 263,400. It had 6 deep water harbours, with a handling capacity of 32,600 ton per year. The annual volume of foreign trade reached more than US$1.3 million, which placed it as the 9th largest trading city in the country, though the value of imports was about ten times bigger than that of exports. 72 percent of Fujian's exports and imports went and came through it, compared with only 28 percent through Fuzhou, the capital city of the province.

4-3-2. The Economic Development from 1949 to 1980

The Chinese Communists took over Xiamen in October 1949 after defeating the Nationalists. Due to its proximity to Taiwan which was occupied by the Nationalists after they fled mainland China, Xiamen was declared as the "frontline of coastal defence" (*Haifang Jianxian*) from 1949 to 1979. Indeed, the distance between Xiamen and Jinmen (Quemoy), one of Taiwan's islets, is so close (about 2,000 metres) that both sides were able to exchange artillery shells from time to time during the three decades of hostility. Consequently, Xiamen was never given the priority in economic development, and capital constructions and normal economic activities had to be kept at the minimal level. However, the construction of the Gaoji Causeway in 1955 and the Ying-Xia Railway in 1957 have, though largely for the military purpose, greatly benefitted Xiamen's economic development, by linking Xiamen with the mainland and indeed with the country's railway network.

Several distinct features have emerged from the economic development during the pre-SEZ period and can be highlighted as follows:

1. *Transformation from the Commercial Seaport into A Costal Industrial City* Because of the expansion and upgrading of other ports in Fujian, such as Fuzhou, Quanzhou, Hangjiang and Xaiqi, the importance of the Xiamen port and its share of cargoes in the province declined steadily. Table 4-3.1 shows that Fuzhou had outstripped Xiamen and become the leading port in Fujian, with its share increasing from 24.08 percent in 1965 to 34.69 percent in 1980 while Xiamen's dropping from 46.08 to 27.38 percent.

Table 4-3.1 The volume and share of cargoes handled by the Fuzhou and Xiamen ports (1965 - 80)
(10,000 ton)

	Fujian's Total	Of which: Fuzhou	%	Xiamen	%
1965	239.87	57.75	24.08	110.53	46.08
1970	211.23	59.26	28.05	102.94	48.73
1975	284.26	120.00	42.21	104.27	36.68
1978	392.41	172.00	43.83	150.01	38.23
1979	557.79	194.58	34.88	150.38	26.96
1980	602.11	208.89	34.69	164.87	27.38

Source: The AFE Editorial Board (1986), p. 495.

On the other hand, industrial and agricultural productions expanded rapidly. Table 4-3.2 demonstrates that from 1950 to 1980 GVIAO grew on average by 10.17 percent per annum, compared with 8.16 percent for Fujian and 7.92 percent for China as a whole over the same period.[21] In particular,industry expanded more than twice as fast as agriculture (12.86% vs 5.62%). As a result, the share of

[21]. The average annual growth rates for Fujian and China are calculated from the data published in the AFE Editorial Board (1986), p. 486 and SSB (1982), p. 17, respectively. All original data were converted into 1957 prices in order to make them comparable.

industry in GVIAO jumped from merely 40.31 percent in 1950 to overwhelmingly 83.14 percent in 1980, indicating a decisive structural transformation in which industry had undoubtedly become the cornerstone of Xiamen's economy.

Table 4-3.2 Growth of the Gross Value of Industrial and Agricultural Outputs in Xiamen (1950 - 80)
(¥10,000, in 1957 prices)

	GVIAO	Of which: Industry	Share(%)	Agriculture	Share(%)
1950	6,210	2,503	40.31	3,707	59.69
1951	6,789	2,639	38.87	4,151	61.14
1952	8,018	2,926	36.49	5,092	63.51
1953	9,279	4,103	44.22	5,176	55.78
1954	8,674	3,905	45.02	4,769	54.98
1955	9,589	4,288	44.72	5,301	55.28
1956	12,374	6,309	50.99	6,065	49.01
1957	15,376	7,991	51.97	7,385	48.03
1958	22,211	14,526	65.40	7,685	34.60
1959	29,971	21,342	71.21	8,629	28.79
1960	41,869	33,354	79.66	8,515	20.34
1961	26,965	20,500	76.02	6,465	23.98
1962	20,844	14,539	69.75	6,305	30.25
1963	20,494	13,746	67.07	6,748	32.93
1964	26,896	18,879	70.19	8,017	29.81
1965	32,281	22,895	70.92	9,386	29.08
1966	39,126	28,919	73.91	10,207	26.09
1967	36,720	24,323	66.24	12,397	33.76
1968	24,557	12,489	50.86	12,068	49.14
1969	43,618	30,843	70.71	12,775	29.29
1970	48,974	35,183	71.84	13,791	28.16
1971	53,284	38,648	72.53	14,636	27.47
1972	59,431	43,767	73.64	15,664	26.36
1973	62,192	48,081	77.31	14,111	22.69
1974	61,656	46,843	75.97	14,813	24.03
1975	66,716	51,291	76.88	15,425	23.12
1976	71,826	56,161	78.19	15,665	21.81
1977	78,165	61,540	78.73	16,625	21.27
1978	91,327	72,927	79.85	18,400	20.15
1979	99,020	80,544	81.34	18,476	18.66
1980	113,420	94,298	83.14	19,122	16.86
AAGR*	10.17%	12.86%	-----	5.62%	-----

* Average annual growth rate.

Source: The AXSEZ Editorial Board (1986), pp. 110-5.

2. *Establishment of A Small but All-Embracing Industrial System* By 1980 Xiamen had already got 490 industrial enterprises (excluding rural and township ones). But of these, 478 were small-sized ones which generated 63.85 percent of the annual GVIO; 9 were medium-sized ones and produced over 22.35 percent of the GVIO; and only 3 were big-sized ones and contributed 13.80 percent of the GVIO (seen Table 4-3.3).[22] This illustrates that the industry in Xiamen, as in many other Chinese cities, was basically small in scale and fragmentary.

Table 4-3.3 Composition of the industrial enterprises in Xiamen by size (1980)

	Number	Share (%)	% of GVIO produced
Small	478	97.55	63.85
Medium	9	1.84	22.35
Large	3	0.61	13.80
Total	490	100.00	100.00

Source: XSB (1982), p. 38.

On the other hand, the industry, though small, encompassed almost all major sectors or branches --- a legacy of the segmented and self-sufficient economy characteristic of the industry in the Maoist era. The 1985 Industrial Survey reveals that Xiamen had 33 of the 40 major industrial sectors identified in China (Research Office, 1989: 124). Of the 33 sectors, the food processing, chemical and pharmaceutical, machinery, textile, paper and stationery, and building material industries had over years emerged as key sectors. Table 4-3.4 shows that in 1981 the seven sectors took more than 83 percent of the GVIO of the year, with the food processing industry being the leading sector.

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[22]. By the Chinese standard, an enterprise with less than 50 employees is generally defined as small-sized one, with between 51 and 999 as medium-sized one, and with more than 1,000 as big-sized one.

Table 4-3.4 Composition of Xiamen's industry by sector (1981)
(¥10,000, in 1980 prices)

	GVIO	Share (%)
Food Processing	26,477	25.52
Chemical & Pharmaceutical	19,772	19.06
Machinery	18,874	18.19
Textile	12,882	12.42
Paper & Stationery	4,488	4.33
Building Material	3,711	3.58
Sub-total	86,204	83.09
Others	17,543	16.91
Total	103,747	100.00

Source: The AXSEZ Editorial Board (1986), p. 72.

3. *Low Level of Capital Investment* As a victim of the military confrontation, Xiamen had received less funds than other cities from the central and provincial governments for capital investment, which includes infrastructure constructions, the purchases of capital equipment and the major technological renovations in enterprises. Table 4-3.5 shows that the periodic growth rates for the funds allocated to Xiamen over the seven periods (from 1950 to 1980) were markedly slower than those for Fuzhou, with the average growth rate being almost four percent behind (111.90% vs 115.89%). As a result, Xiamen's shares in Fujian's total capital investment funds had been persistently and noticeably smaller than those for Fuzhou, with the average share being nearly two percent smaller (6.63% vs 8.60%). Without doubt, this neglect of capital investment has been responsible, to a large extent, for many problems faced by Xiamen in the present development of the SEZ.

Table 4-3.5 Growth of capital investment in Xiamen and Fuzhou in seven different periods of economic development (1950 - 1980)

Period	Fujian	Xiamen			Fuzhou		
	Amount (¥10,000)	Amount (¥10,000)	G.R.[a] (%)	Share (%)	Amount (¥10,000)	G.R.[a] (%)	Share (%)
Rehabilitation (1950-52)	7,987	343	-----	4.29	432	------	5.41
1st FYPP (1953-57)	85,470	4,362	1171.72	5.10	4,828	1017.59	5.65
2nd FYPP (1958-62)	235,224	20,488	369.69	8.71	22.856	373.44	9.72
Adjustment (1963-65)	72,522	4,100	-79.99	5.65	5,166	-77.40	7.12
3rd FYPP (1966-70)	103,702	3,001	-26.80	2.89	4,092	-20.79	3.95
4th FYPP (1971-75)	256,119	10,336	244.42	4.04	14,367	251.08	5.61
5th FYPP (1976-80)	349,563	31,048	200.39	8.88	43,738	204.43	12.51
Total	1,110,587	73,678	111.90[b]	6.63[c]	95,479	115.89[b]	8.60[c]

Notes: a: Growth rate over the previous period; b: Average periodic growth rate; and c: Average share.

Sources: 1). Fujian: FSB (1989), p. 223;
2). Xiamen: The AXSEZ Editorial Board (1986), pp. 116-7;
3). Fuzhou: FZSB (1985), p. 275.

4. *Low Level of Technology in Enterprise* As a result of neglect and under-investment, plus the effect of the over-centralized control of the depreciation funds, most industrial enterprises in Xiamen were characterized as those with "four old's" (*Silao*) --- old buildings, old equipment, old production techniques, and producing old products. Indeed, 86 percent of the equipment and production techniques in the enterprises in the early 1980s were classified, by the Chinese standard, as those of the 1950s and 1960s (see Table 4-3.6). Not surprisingly, the overall level of the industrial technology in Xiamen lagged far behind the national average (Du Qiang, 1988: 58).

Table 4-3.6 Composition of the industrial technologies in Xiamen's enterprises in the early 1980s by level (%)

	1950s	1960s	1970s	1980s	Total
Equipment	76.0	10.8	8.2	5.0	100.0
Production Technique	63.0	23.0	14.0	0.0	100.0

Source: The YCSEZ Editorial Board (1987), p. 253.

5. *Reduced Importance of Exports* Equipped with out-of-date technology, Xiamen was unable to produce competitive export goods. Table 4-3.7 reveals that from 1962 to 1980 Xiamen's exports grew on average by mere 12.20 percent per year, compared with 18.54 percent for Fujian's total (both figures include inflationary elements). In particular, during the peak time of the Cultural Revolution Xiamen's exports

Table 4-3.7 Growth of Xiamen's exports (1962 - 1980)

	Fujian's Total Exports		Xiamen's Exports		
	Volume (¥10,000)	G. R.[a] (%)	Volume (¥10,000)	G.R.[a] (%)	Share in Total (%)
1962	2,538	-----	1,485	-----	58.51
1963	3,181	25.33	1,986	33.74	62.43
1965	6,270	97.11	4,350	119.03	69.38
1966	7,728	23.25	3,504	-19.45	45.34
1970	8,705	12.64	3,011	-14.07	34.69
1971	9,702	11.45	2,565	-14.81	26.44
1975	23,695	144.23	5,316	107.25	22.44
1976	21,887	-7.63	5,874	10.50	26.84
1980	54,185	147.57	11,783	100.60	21.75
AAGR[b]	------	18.54	------	12.20	-----

Notes: a: Growth rate over the previous figure; and b: Average annual growth rate over the period of 1962-80.

Sources: 1). Fujian: The FSB Editorial Board (1990), p. 108;
2). Xiamen: The AXSEZ Editorial Board (1986), pp. 122-3.

suffered a steep decline, from ¥43.5 million in 1965 to ¥25.65 million in 1971, despite the steady growth of the total export

volume for Fujian over the same period. This led to a drastic reduce in its contribution to Fujian's exports, from 69.38 percent at the height time (1965) to only 21.75 percent in 1980, illustrating the declining importance of exports in Xiamen's pre-SEZ economy.

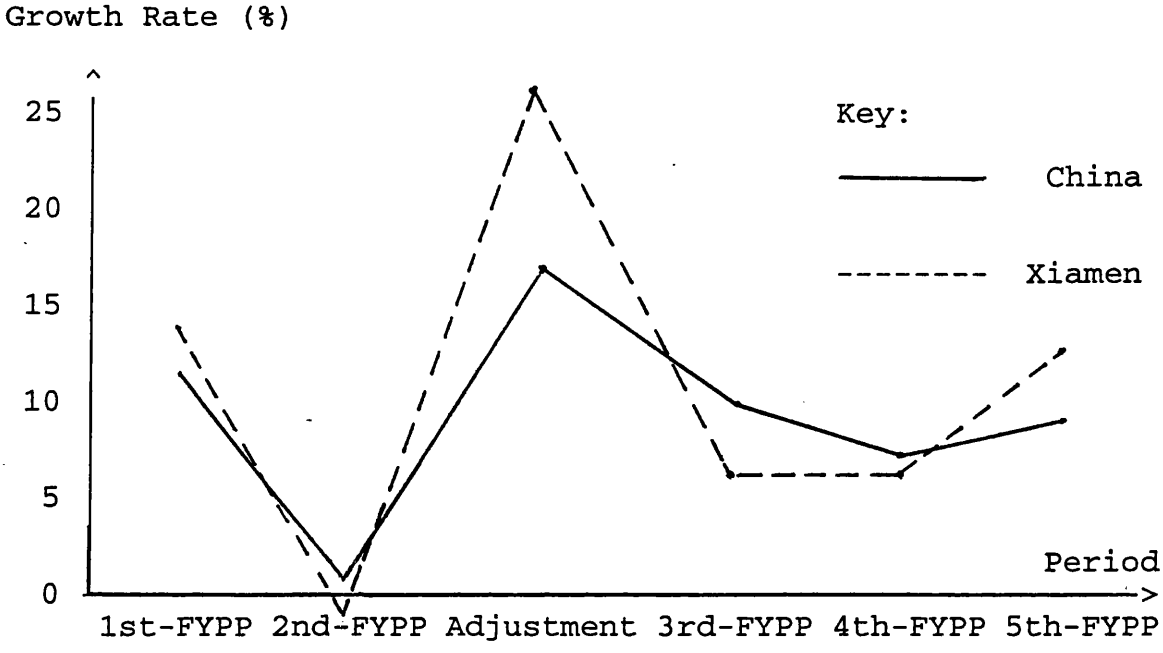
6. *Big Fluctuations in Economic Growth* Since the establishment of the centrally planned economy, Xiamen's economy experienced three upswings and two downswings in the three turbulent decades (1950 - 1980). Table 4-3.8 and Figure 4-3.3 demonstrate that Xiamen's economy fluctuated in line with, but with greater amplitude than, the general trend of the national economy in the six different periods. Thus, Xiamen witnessed upsurges of its economy in the 1st FYP period, the Adjustment period and the 5th FYP period, but experienced sharp downfalls during the campaigns of the Great Leap Forward (the 2nd FYP period) and the Cultural Revolution (the 3rd and 4th FYP periods). This suggests that Xiamen's economy had been fully integrated into China's central planning and management systems and would therefore be responsive fully to the domestic economic cycle.

Table 4-3.8 The average annual growth rates of GVIAO in Xiamen and China in six different periods (1953 - 1980) (%)

	Xiamen	China
1st FYP period (1953 - 1957)	13.5	10.9
2nd FYP period (1958 - 1962)	-1.6	0.06
Adjustment period (1963 - 1965)	25.5	15.7
3rd FYP period (1966 - 1970)	5.8	9.6
4th FYP period (1971 - 1975)	5.8	7.6
5th FYP period (1976 - 1980)	12.1	8.1

Sources: 1). Xiamen: Table 4-3.2;
2). China: SSB (1989), p. 53.

Figure 4-3.3 The average annual growth rates of GVIAO in Xiamen and China in six different periods (1953 - 1980)



Source: Table 4-3.8.

To sum up, after three-decades of development under the centrally planned economic system, Xiamen had built a comprehensive but under-developed industrial system. Its industry grew on average by 12.86 percent per annum during the period of 1950-80, the labour productivity by 4.53 percent, and the people's living standard by 1.46 percent, compared slightly favourably with 12.46 percent, 4.17 percent and 1.41 percent for the corresponding national figures.[23]

However, its economic development was constantly handicapped by the restrictions imposed on it by the central government because of its potential vulnerability to the military confrontation with Taiwan. As a result, its industry and basic infrastructures were chronically under-invested and severely under-developed. Industry was small, fragmentary and

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[23]. The indicator of the People's Living Standard is represented by the Index of the Real Average Wage of Urban Workers and Staff.

For Xiamen's figure, see Table 3-3.2 and The AXSEZ Editorial Board (1986), pp. 112-3 and pp. 130-1; for the national figures, see SSB (1983), p. 216 and (1990), p. 65.

showed little signs of interdependence and linkages among various sectors. The combination of the industrial problems and the rigid planning and management system made Xiamen's industry chronically inefficient and lacking in dynamism.

4-3-3. The Reform and Development since 1980

As a result of the establishment of the SEZ in 1980, Xiamen faced the unprecedented challenge of combining the reform of the old economic system with the development of a new, open one. The expansion of the SEZ to the whole Xiamen Island in 1984 has not only increased the SEZ territory from 2.5 to 131 sq km but, more profoundly, embedded its 588 existing enterprises situated in the urban areas of the Xiamen Municipality, apart from the 180 already established in Huli District since 1981. As a result, it became clear that the performance of the mainstay of the SEZ's economy, i.e. the 588 old enterprises, would be vital to the success of the SEZ. This means that the restructuring of the old command economic system and the revitalization of the outmoded enterprises, in the light of the new development strategy, had to be put on the top agenda of reform and development.

Accordingly, immediately after the expansion, the Xiamen Municipal Government, now an effective SEZ government, declared that "the economic structural reform is the top priority" for the SEZ, and that the reform direction was to "turn the closed, inward-looking economy into an open, outward-looking one" (ACE Editorial Board, 1985: VII-36).

The central government understood the unique situation of the SEZ and the national significance of its reform to the ongoing industrial reform. Consequently, Xiamen became the *only SEZ* which was chosen, together with other 16 cities, as a pilot city for comprehensive industrial reform in early 1986 (Wang Luolin, 1986: 10). In April, the State Council took another decisive step by granting the Xiamen SEZ the right of Independent Planning. This meant that the SEZ would, from 1989, be treated as a province-level unit in the country's

planning system, and thereby be able to bypass the Fujian provincial authorities to directly participate in all of national economic activities (*RMRBh*, 31/8/88: 3). These steps show clearly the Chinese authorities' intention to turn the Xiamen SEZ into a "laboratory" for the concurrent national economic reform.

Reforms and Changes

Mr. Zou Erjun, the mayor of Xiamen, has summarized the major reform measures and subsequent changes that took place in Xiamen's industrial and trade systems[24]:

1. The closed, segmented and hierarchical economic system has gradually been replaced by an open, dynamic and horizontally connected one. Indeed, the rapid proliferation of various kinds of HEAs among foreign, interior and the zone partners has been the single most noticeable feature of the development in the SEZ in recent years. By the end of 1990, the number of various HEAs had reached 1,090, involving a total investment of ¥1,017 million, of which ¥818 million came from interior regions (AXSEZ Editorial Board, 1991: 116).[25] At the same time, the SEZ had established economic and technological cooperation links with 26 provinces/ municipalities/autonomous regions, 25 central ministries and 22 universities/colleges/research institutes. On the other hand, 110 local governments in the interior had set up their representative offices in Xiamen (ibid, 1990: 46).

2. Macroeconomic management has been improved, with the substitution of the indirect regulation through economic and legal levers for the direct control via administrative means. A key feature of this reform has been the drastic reduction of

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[24]. See Zou Erjun (1988). In order to illustrate Zou's points, data from other official sources, as indicated, are also used.

[25]. The Xiamen authorities have specifically encouraged the development of inward-linked economic associations (*Neilian Qiye*) in the SEZ. For details of the relevant policy and regulations, see Appendix D.

the scope of the mandatory plan and the establishment of factor and product markets. Today, more than 70 percent of inputs needed by enterprises come from, and about 90 percent of products produced by local enterprises go to, unregulated or free markets.

3. The single-public-ownership system has been replaced by a multiple-ownership one. As a result of the rapid proliferation of various kinds of HEAs, the share of the industrial outputs produced by non-public sectors had climbed steadily from nothing in 1981 to 56.25 percent in 1990, while that for the public sectors declined firmly from 99.98 percent to 43.75 percent (ibid, 1991: 44). That is to say, by 1990 the non-public economy, most of which were the mixture or associations of various public and private (including foreign) sectors, had already become the dominant economic force in Xiamen. Obviously, this has laid down a good foundation for the further development of a market-oriented economy in the SEZ.

4. Most enterprises have been restructured through the far-reaching decentralisation of decision-making powers (*Jianzheng Fangquan*) in the light of the principle of separating ownership and management. Since the early 1980s they have experienced a variety of reform programmes, including the removal of price subsidies, the substitution of taxation for profit delivery, the contract-responsibility-system and, more recently, the separation of tax and profits.

In addition, a dozen of COEs have become joint-stock companies by issuing shares to their workers and staff, and 11 small and unprofitable public plants have been sold or leased to other organisations or private individuals, including foreigners (Research Office, 1989: 220; Su Yanhan 1989). All these measures were intended to increase the autonomy of enterprises and make them accountable to their own operations.[26]

5. The price reform has been characterized by the

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[26]. For detailed analyses of the enterprise reform, see Chapter 5.

replacement of the traditional single-fixed-price system by a three-tier system of fixed, floating and free prices. The numbers of commodities controlled by the Provincial Price Committee had dropped from 712 in 1979 to 48 in 1988. While most enterprises have been allowed to set prices for their products (excluding those subject to the state direct control), the major effort was put on stabilizing the aggregate level of prices (Zhu Guanghua, 1988).[27]

6. The foreign trade reform has produced two major achievements. 1). The decentralization of the right of dealing in foreign trade had resulted in the increase in the number of trading entities from 8 to 139 by 1988, thus creating certain degree of competition among the state-controlled trading corporations, local smaller trading companies and key manufacturers. 2). The introduction of the CRS, which links the total amount of foreign exchange earned and the level of profits/losses to all-levelled sections and individuals in a trading company, has significantly improved the efficiency of business operations. For example, in 1988 the average costs of earning one US dollar went down sharply, ¥0.37 less than the target fixed by the provincial government. As a result, ¥3.96 million has been saved (AFE Editorial Board, 1988: 91).[28]

7. The radical financial and monetary reform has led to the establishment of a new, open and multiple-layer monetary system, which is centred by the People's Bank of China, dominated by the state specialized banks, and supplemented by foreign banks, Chinese-foreign joint banks, local monetary and credit cooperatives. Indeed, Xiamen has made a lot of efforts to diversify the channels of raising funds and the means of business credit. Xiamen is particularly proud of the fact that China's first Chinese-foreign joint bank, the *Xiamen International Bank*, was set up in Xiamen in 1987.

8. The employment reform has been carried out in full

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[27]. For the further discussion of the price reform, especially in relation to the trade reform, see Chapter 7.

[28]. For more detailed analyses of the trade reform and its relationship with the price reform, see Chapter 7.

swing. Instead of being offered lifelong jobs, many people in Xiamen are now employed on contract base through the newly established labour markets and the professional exchange agencies. Enterprises have the right to recruit or dismiss their workers and staff, and to hire technical and managerial personnel from home and abroad. By 1988 some 21,600 contracted workers and professionals had been employed in Xiamen (Zheng Jinmu and Huang Shengzhi, 1988).

Performance of the Economy

Xiamen has made a great deal of effort to improve its infrastructure ever since becoming a SEZ. Of most significant concern was the strengthening of its connections with the outside world. Four deep-water berths (two for 50,000-dwt ships and two for 100,000-dwt ships), one of which was designed for container traffic, have been built in the Dongdu Harbour. In 1983, the Xiamen International Airport was opened, linking it with some 25 major domestic and foreign cities. In the same year, the 220-km Yongan-Xiamen power transmission line (220,000 volts) was completed. In addition, a digitized telephone exchange was introduced and a microwave telecommunication system installed.

At the same time, Xiamen has been able to speed up its economic development as the reform accelerated. The national income grew on average by 16.74 percent per annum from 1981 to 1990, compared with only 9.40 percent for the pre-SEZ period of 1950-1980. This has pushed up the national income per capita to ¥3,850 in 1990, 206.77 percent more than that in 1980 (AXSEZ Editorial Board, 1991: 250).[29]

The industrial and export sectors have made an impressive progress. The average annual growth rates for them during the

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[29]. According to Perkins (1988), the most convincing figure for showing positive or negative impacts of the reform on the economic performance is "the growth rate of what the Chinese call 'national income' but which Western economists usually refer to as Net Material Product (NMP)". See Perkins (1988), pp. 627-8.

period of 1981-90 were 23.24 percent and 21.94 percent respectively, all substantially higher than the national rates over the same period (13.56% and 10.68%) and their record for the pre-SEZ period (12.86% and 16.88%) (see Table 4-3.9).

Table 4-3.9 The industrial and export growth in Xiamen (1950 - 1990)

Year	GVIO (¥10,000, in 1980 prices)	Exports (US$10,000)
1950	2,503	130.41
1980	94,298	14,027.38
Average annual growth rate (%)	**12.86**	**16.88**
1981	103,885	13,112.19
1982	113,180	12,401.68
1983	120,211	12,380.90
1984	150,855	15,584.66
1985	218,522	16,527.49
1986	246,864	16,374.25
1987	328,567	26,107.17
1988	481,600	57,607.00
1989	565,400	64,678.00
1990	681,627	78,148.16
Average annual growth rate (%)	**23.24**	**21.94**
National average annual growth rate (%) (1981-90)	**13.56**	**10.68**

Sources: 1). 1950-85: AXSEZ Editorial Board (1986), pp. 112-3 & 122-3;
2). 1986: XSB (1987), pp. 13 & 350;
3). 1987: XSB (1988), pp. 13 & 328;
4). 1988-89: AXSEZ Editorial Board (1990), pp. 154 & 324;
5). 1990: AXSEZ Editorial Board (1991), pp. 221 & 227;
6). The national rates: calculated from the data in Table 2-3.1 and Table 3-1.2.

Based on these achievements, Mr. Zou proudly announced that "the industrial reform has achieved a huge success and the outward-looking economy has basically been built up" in the Xiamen SEZ (*RMRBh*, 14/10/89: 2).

4-3-4. Summary[30]

Xiamen is blessed with a variety of location advantages, which could greatly expedite the development of the SEZ if they are utilized properly. They can be highlighted as follows:

1. *Favourable Geographical Conditions* As a port, Xiamen is located right between the two most dynamic and affluent areas in today's China --- the Yangtze and Pearl valleys --- and on many of the southern and eastern China coastal traffic routes, which means that entrepôt trade will be an important part of its economic activities. Furthermore, Xiamen's harbour, which is protected by a series of islands along the 43 km of deep-waster coastline, is the best among all the SEZs.

In addition, Xiamen's climatic conditions are ideal for the development of an export-oriented agriculture and fishery industry.

2. *A Long History of Overseas Trade* With a history of more than 600 years of foreign trade, Xiamen's experience in dealing with foreign trade is undoubtedly of immense value to its present drive to develop an export-oriented economy.

3. *A Special Link with Overseas Chinese and Taiwanese* The unique link is an important asset for Xiamen because it not only represents an important source of foreign exchange remittance and direct investment but also exerts a profound impact on the future shape of the SEZ.

4. *A Relatively-Developed Industrial and Commercial Base* This advantage enables Xiamen to develop and improve its export manufacturing, financing, distributing, and marketing capacities more quickly and efficiently than other SEZs.

5. *A Sizable Pool of Professionals and Skilled Workers* Xiamen has the highest density of higher education institutions and university graduates among all SEZs. It was estimated that 40 out of every 1,000 people have received

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[30]. This section draws extensively on Li Si-ming and Zhao Ling-xun (1992).

higher education, a ratio six times higher than the national average.

6. *Rich Tourist Resources* Dubbed as "a garden on the sea," Xiamen attracted more than one and half million of domestic and foreign tourists annually in the late 1980s,[31] and indeed had the highest revenues from tourism among all the SEZs.

On the other hand, Xiamen's further development could be constrained by several geographical, economic and political factors. They include:

1. *A Limited Hinterland* Xiamen's hinterland only covers the neighbouring southern and southwestern Fujian regions, with a total areas of 67,000 sq km and a population of 14 millions. The combined GVIAO for these regions in the mid-1980s was about ¥10 billion, which is only equivalent of a medium-sized city's level. Compared with the hinterland the three SEZs in Guangdong have (the Pearl River valley, some parts of Hunan and Guangxi provinces), Xiamen's is far too small and less developed.

2. *Chronical Shortage of Power and Water Supplies* This shortcoming has for years served as the "bottleneck" to Xiamen's further development, deterring foreign investors from making further or bigger investment.

3. *Over-Strained Surface Transportation* The capacity of the Causeway and the Ying-Xia Railway is too small to meet the growing traffic demands. Every year an estimated 5-6 million tonnes of goods needed by Xiamen cannot be transported to the city because of the inadequate rail capacity.

4. *A Large Number of Small-Sized, Inefficient Enterprises* These old, mostly public-owned enterprises, some of which are still making losses now, form the majority of the industrial enterprises and employ about 70 percent of the total workforce in Xiamen. Hence, to restructure them is clearly a daunting task.

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[31]. The number of foreign tourists (including Taiwanese) in 1990, for example, reached 210,800 (AXSEZ Editorial Board, 1991: 114).

5. *Potential Threat of Military Confrontation* Although the atmosphere in the Taiwan Straits has become more and more relaxed in recent years, the threat of using forces by one side against the other has never been removed. As a result, the economic integration and further cooperation between the two sides have been circumscribed considerably.

Chapter 5

THE ENTERPRISE REFORM IN XIAMEN

After the enlargement of the Xiamen SEZ from the original Huli District to the whole Xiamen island (including the Gulangyu Islet) in 1984, the SEZ authorities seized the opportunity to upgrade the development goal of the SEZ from an EPZ-type zone to a comprehensive, industrial-oriented economic zone. The new development objective states that:

> "In the long run, the Xiamen SEZ should be built into a comprehensive and outward-looking economic zone with characteristics of a Free-Trade-Port. It will mainly develop industry but at the same time also manage tourism, commerce and real estate" (AXSEZ Editorial Board, 1986: 1).

Facing the reality that the bulk of the SEZ's economy was 588 small and medium-sized, mostly public-owned, outmoded industrial enterprises, the authorities sorted out development priorities and formulated a short-term policy in the light of the long-term objective. They identified the rejuvenation of the existing enterprises, by radical economic management reform and technological innovation, as the key to the development of a competitive export-oriented industry. In terms of the economic reform, the policy stipulates two priorities:

> "The present economic reform should focus on, at the micro level, rejuvenating industrial enterprises, especially big- and medium-sized ones, and, at the macro level, restructuring the price system both for goods and services. This is intended to create a sound macroeconomic environment and force the enterprise to increase its operational efficiency and international competitiveness" (ibid: 12-3).

This chapter will examine the economic reform at the micro level, i.e. the enterprise reform, in the Xiamen SEZ. The macro reform, namely the price reform, will be dealt in conjunction with foreign trade reform in Chapter 7; while technological innovation will be examined in connection with the utilization of FDI in Chapter 6.

As the term *industry* is used in a variety of different ways in the Chinese economic literature, it is necessary therefore to strictly define the types of the activities to which the term is limited. In this thesis, the term *industry* refers only to *manufacturing*, i.e. the major division 3 in the International Standard Industrial Classification (ISIC).[1]

Most industrial enterprises in Xiamen (especially in the urban area) are in the public-owned sector, i.e. either SOEs or COEs. Therefore, the discussion in this thesis will focus on the public-owned enterprises, especially SOEs. A SOE, according to a World Bank publication, is defined as:

> "(a) a government owned productive organization that (b) is expected to earn a significant portion of its revenues from the sale of the goods or services it produces, (c) possesses an accounting system separate from any government agency that controls or supervises it, and (d) is a distinct legal entity" (Shirley, 1983: 2).

Thus, Section 5-1 is to explain the significance and policy of the enterprise reform in Xiamen; Section 5-2 examines the first stage of the reform; Section 5-3 presents three major different perceptions of the reform problems; Section 5-4 goes on to analyze the second stage of the reform; and finally Section 5-5 concludes this chapter.

5-1. The Significance and Policy of the Reform

As introduced in the proceeding chapter, 588 old industrial enterprises in Xiamen have proved to be a major

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[1]. For more information about the ISIC system, refer to Kirkpatrick, *et al.* (1984), pp. 2-4.

obstacle to its ambition to build up a dynamic exporting industry. In particular, the old, Soviet-style management system of these enterprises have been most problematic.

Since the implementation of the economic reform and "open-door" policy in Xiamen, many TVEs have operated with much greater autonomy from the framework of central planning and are thus able to avoid many problems stemming from that system. On the other hand, individual private businesses and FIEs have operated almost totally free of bureaucratic restriction and have achieved faster growth.

As a result, the local SOEs were losing share in the market daily and, indeed, faced the danger of being swallowed by the fast expanding private (including foreign-owned) economy. Thus, a enterprise reform aimed at rejuvenating the rundown local enterprises, especially the SOEs, is both inevitable and imperative.

The Significance of the Reform

Reform of SOEs is the cornerstone of the economic reform programme in almost all socialist and formerly socialist economies, and it is also an important component of the economic liberalization policy carried out by many developing countries in the last two decades or so. Thus, the enterprise reform in Xiamen is not only crucial to the success of the SEZ but also has profound implications for the economic reform in China and indeed for other reforming socialist, former socialist and developing countries as well. This is because:

1). Since 1984 China has constantly and unequivocally put enterprise reform at the centre of the industrial reform. This can easily be verified in almost every official reform document. The essence of enterprise reform in China is "to separate government function and enterprise business, or enterprise management and ownership." This is intended "to give bigger decision-making power to enterprises in their daily businesses and force them to be responsible to their own profits or losses" (Central Committee, 1984). Yet the reform

has, as shown in Chapter 3, not achieved the goal yet.

With the implementation of the Special Policy in the SEZ, however, the reform in Xiamen, a typical small and medium industrial city in China, has the potential to add fresh impetus to the almost stagnant domestic enterprise reform. Indeed, the fact that Xiamen was designated as a pilot city for comprehensive economic reform in 1986 clearly shows the important role Xiamen is expected to play --- acting as a *laboratory* for the ongoing domestic economic reform. Thus, the enterprise reform in Xiamen is not only crucial to the development of its export-led industrial economy but also has a great bearing on the domestic economic reform.

2). As in China, the SOE in most socialist and the formerly socialist countries is the dominant sector in the economy and has generally not performed well. Most socialist economies have lengthy histories of enterprise reform, in which they tried to increase operational efficiency of their SOEs by substituting market-like mechanisms for the command mechanisms of plan fulfilment. However, as introduced in Chapter 1, they have failed to improve the efficiency, productivity and related performance levels of their SOEs, many of which are now either deteriorating or even collapsing.

With the vigorous introduction of foreign capital, especially the rapid development of FIEs side by side with SOEs, the enterprise reform in Xiamen presents a dimension new to the reform of socialist and the formerly socialist economies, and may thus be able to answer, at least partly, the question why the previous reforms have never been successful.

3). China's enterprise reform, particularly in terms of increasing enterprise autonomy and raising productivity, is, as described in Section 1-5-1, "in many respects similar in nature to" the economic liberalization carried out in a number of developing countries. The essence of this liberalization is to "reduce the hold of the government bureaucracy over the economy and to replace bureaucratic direction with the

impersonal forces of the market" (Perkins, 1988: 603).[2] Thus the enterprise reform is by no means unique to the Xiamen SEZ or, indeed, to any socialist economy, but is an important component of industrialization policy for all developing countries.

4). In view of the Xiamen SEZ's task to attract foreign capital to develop an export-oriented industry, the enterprise reform is actually an important step for the SEZ government to take to improve its economic policy environment, or "soft infrastructure," as it is called locally, for foreign investment.

Experience in many EPZs throughout the world has shown that the soundness of the *general economic policy* pursued by host countries, rather than the policies relating specifically to foreign investment, is a major factor determining the net gains or losses of foreign investment.[3] Indeed, the foreign observers who attended the international seminar held in Xiamen in 1987, clearly pointed out that "a market-oriented and open policy environment is crucial" if Xiamen and other SEZs are to be successful. They argued that "no amount of interest and support from the national and zone authorities would be able to counterbalance the negative impact of an inappropriate policy and institutional environment" (Brogan, 1988: 8).

That is why many western investors have recommended developing countries to reform their domestic economic system before introducing foreign capital.[4] Thus Xiamen's enterprise

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[2]. János Kornai has a splendid analysis of the nature of this type of liberalization. See particularly Kornai (1986).

[3]. For more about the importance of the general economic policy of the host country in attracting foreign investment, see Moran, *et. al.* (1986), pp. 95-6; James, *et. al.* (1987), pp. 22, 27 and 101; Chenery, *et. al.* (1986), p. 358; and Reuber, *at. el.* (1973), pp. 243-8.

[4]. For more details of the policy reform in the developing countries/regions which pursued export-led industrialization, see chiefly Linnemann, *et al.* (1987); Moran, *et al.* (1986) and Balassa (1977).

reform, involving the introduction of market forces into enterprise operations and hence creation of an environment sympathetic and compatible to private economy, undoubtedly represents such important initiative, apart from being an integral part of the Chinese domestic economic reform.

The Reform Policy

The enterprise reform in China contains, according to the Reform Decision, two important and interrelated issues: first, the relationship between the state and the enterprise, and second, the restructuring of the internal operational mechanism of enterprise. Based on this official line, the Xiamen SEZ authorities worked out their own reform policy, which, they claimed, had taken Xiamen's development objective into account. This reform policy was unveiled in an officially published book --- *Xiamen Socio-Economic Development Strategies for 1985 - 2000*. It calls for carrying out an "unprecedentedly radical economic structural reform" in order to "create sound micro- and macro-economic environments conducive to the development of an export-oriented outward-looking economy." The reform should, it declares, "focus on rejuvenating existing enterprises by applying market mechanisms to them and forcing them to operate in the light of international business rules" (Research Office, 1989: 129).

As a first step to the enterprise reform, the authorities decided to abolish the huge financial subsidies they had over years put into inefficient and loss-making enterprises. This was intended, on the one hand, to "reduce the government's financial burdens and readjust the relationship between the state and the enterprise" and, on the other hand, to "strengthen financial discipline or harden budgetary constraints on enterprises and thus restructure their operational mechanisms." In the meantime, the authorities also stressed that removal of subsidies on the enterprises must be carried out "in close coordination with price, wage, tax, credit, and financial reforms" (ibid; Zhu Guanghua, 1988).

5-2. The First Wave of the Reform: Removing Price Subsidies

As described in Section 4-3, Xiamen, like hundreds of China's small and medium industrial cities, possessed an outmoded but all-embracing industry, which had no obvious leading sector based on its own comparative advantages and the market conditions. A typical characteristic of this type of industry is that the costs of production tend to be very high. With the implementation of the reform and "open-door" policy, the financial position of SOEs became increasingly precarious. For example, Xiamen Biscuit Factory, the pillar of the food processing industry in the SEZ, mainly relied on manual operations to produce its products. At the same time, it had to pay high prices to get raw materials due to the fierce competition from rapidly developing TVEs. As a result, the costs of its production were much higher than those of its counterparts in neighbouring Guangdong province. Indeed, the whole Xiamen biscuit market was facing the danger of being taken over by Guangdong (Du Qiang, 1988).

However, the food processing industry was one of Xiamen's key industries, employing several thousands of workers, making up 17-20 percent of the SEZ's total GVIO, and providing 35-40 percent of total exports (Research Office, 1989: 125). Clearly, the authorities could not afford to let it go bankrupt. Instead, they rescued it by putting a huge subsidy on the prices of its outputs[5]. Xiamen Tinned-Food Factory and Xiamen Bicycle Factory faced the similar situation (ibid).

A local economist disclosed that every year the authorities had to spent about ¥60 million on such price subsidies in order to bail inefficient and loss-making enterprises out (Zhu Guanghua, 1988). This huge financial burden severely handicapped the authorities' ability to carry out key infrastructure constructions, central to the

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[5]. Of course, the subsidies sometimes also went to the purchase of inputs. Many enterprises facing the crisis often received inputs with "reasonable prices" from government agencies. See the Research Office (1989), p. 177.

development of the SEZ. Consequently, they had no option but to choose the elimination of the subsidies as the first priority of the enterprise reform.

The authorities originally planned to eliminate *all* kinds of price subsidies outright and divert the subsidy fund totally to wages of all workers and staff in local enterprises and governmental establishments to compensate for the imminent price rise in the market. This would, in their words, turn the "invisible subsidies" (on prices) into "visible subsidies" (on wages). They estimated that the price level would go up by about 3 percent due to the removal of the subsidies, and the share of wage in the costs of production up to about 10 percent (from previously 7-8 percent) because of the increase in wages.

Based on this estimation, the authorities confidently predicted that the increase in prices would be met by the simultaneously increased wages, while the extra costs of production could be absorbed by most enterprises through an improvement in productivity. Even if some enterprises might fail to achieve that and hence suffer a reduction in their profits, the pressure on the total financial revenues of the SEZ government would be fairly minor, since the government would no longer have to increase the price subsidies annually as it used to (Zhu Guanghua, 1988).[6]

Unfortunately, this first reform programme was soon hampered by a few obstacles and made little headway. The authorities clearly underestimated the extent of the price increase and over-estimated the capacity of enterprises to absorb the extra costs of production. As shown in Table 5-2.1, in 1985, when the removal of subsidies was carried out in full scale, the People's Living Costs Index, composed of the retail price indexes for both consumer goods and services, suddenly jumped to 22 percent, compared to 7.4 percent in the previous

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[6]. In fact, Mr. Zhu Guanghua, a scholar in the Fujian Academy of Social Sciences, claimed that the reduced amount of the profits of those enterprises was equal to the annual increasing amount of the price subsidies the government would otherwise have to put on the enterprises. See Zhu (1988).

year, then to nearly 29 percent in 1988 and indeed had never come back to the original level since.[7]

Table 5-2.1 The people's living costs index (PLCI) in Xiamen (1981 - 1989)
(previous year as 100)

Year	81	82	83	84	85	86	87	88	89
PLCI	104.3	102.2	102.3	107.4	122.0	109.4	112.1	128.9	124.0
Of which:									
Goods	104.7	102.6	101.9	107.2	123.1	109.8	111.9	130.1	124.8
Serv.	100.6	100.5	107.1	109.5	112.2	104.8	114.3	114.7	115.2

Sources: 1) 1981-85: the AXSEZ Editorial Board, (1986), p. 91;
2) 1986: XSB (1987), pp. 340-1;
3) 1987: XSB (1988), pp. 320-1;
4) 1988: XSB (1989), pp. 352-4;
5) 1989: XSB (1990), pp. 305-6.

While consumers suffered from the high inflation, most manufacturers also endured substantial losses in their profits. This was because they, on the one hand, failed to improve their productivity to absorb the extra input costs, and, on the other hand, could not pass on the extra costs to the consumers due to the restriction imposed by the government. It was reported that about 50-60 percent of SOEs suffered, to various degrees, such losses (Luo Huiming, 1988).

As a result, the call for a drastic cut in their profit tax became increasingly strong among SOEs, which had to pay the tax at 55 percent rate. Indeed, the need for tax reduction became more pressing as the government had been accused of organising an unfair competition, since all foreign-invested and domestic-associated enterprises in the SEZ only pay 15 percent in the light of the Special Policy.[8] Why then was the government reluctant to cut the tax rate of its own

[7]. There are no accurate data available about the extent of price increase in producer goods, but nor is there any reason to suggest that the extent was lower than that of consumer goods.

[8]. See Article 6, Appendix D.

enterprises?

As described above, the government finance in the SEZ was under an intense pressure due to the fact that financial revenues had grown slower than the economic growth, on the one hand, and that the demand for a greater financial expenditures for capital construction had become ever stronger, on the other.

As can be seen from Table 5-2.2, the growth rates of the total financial revenues were markedly lower than those of the national income from 1985 to 1989, reflecting the difficult situation of the government finance. Also, the profit tax paid and the profit deliveries made by the local enterprises accounted for nearly 87 percent of the total financial revenues in 1985, indicating the crucial role played by them in raising government revenues.[9]

Table 5-2.2 Annual growth rates of national income, total government financial revenue, and the share of enterprise contribution in the Xiamen SEZ (1985 - 1989)
(¥100 million, in current prices)

Year	85	86	87	88	89
National income	8.69	13.52	17.23	28.69	38.96
Annual growth rate (%)	----	55.58	27.41	66.51	35.78
Total financial revenue	4.41	5.65	7.01	10.43	13.47
Annual growth rate (%)	----	28.12	24.07	48.79	29.15
Of which:					
Enterprises' profit tax and deliveries	3.83	4.54	4.92	6.12	7.79
Annual growth rate (%)	----	18.54	8.37	24.39	27.29
Share in total revenue(%)	86.82	80.35	70.19	58.68	57.83

Sources: 1). 1985: XSB (1986), pp. 70 & 401;
2). 1986: XSB (1987), p. 363;
3). 1987: XSB (1988), pp. 12 & 339;
4). 1988: XSB (1989), p 377;
5). 1989: XSB (1990), pp. 166-8.

[9]. In China, the total government financial revenues is composed of budgetary and non-budgetary revenues. The first group, making up about 80 percent of the total, comes mainly from the profit tax and the profit delivery of local enterprises, while the second primarily from the revenues of the local governmental administrative departments.

However, despite strong growth of the total financial revenue over years, the share contributed by the enterprises dropped steadily: from 86.82 percent in 1985 to 57.83 percent in 1989. This can be explained by the fact that the annual growth rates of the enterprise contribution from 1985 to 1989 were substantially lower than those of the total financial revenue over the same period, manifesting a declining position of the enterprises as a major contributor to the government coffers.

Table 5-2.3 Growth of the total financial revenue and capital construction in Xiamen (1984 - 1989)
(¥100 million, in current prices)

Year	1984	1985	1986	1987	1988	1989
Financial revenues	3.62	4.41	5.65	7.01	10.43	13.47
Growth rate(84 as 100)	----	21.82	56.08	93.65	188.12	272.10
Capital construction	4.61	11.72	9.89	10.65	13.37	17.73
Growth rate(84 as 100)	----	154.23	114.53	131.02	190.02	284.60

Sources: 1). Financial revenue: Table 5-2.2;
2). Capital construction:
a). 1984-85: the AXSEZ Editorial Board (1986), pp. 83 & 95;
b). 1986: XSB (1987), p. 187;
c). 1987: XSB (1988), p. 131;
d). 1988: XSB (1989), p. 159;
e). 1989: XSB (1990), p. 256.

In contrast to this relative stagnation of revenue, the demand for more funds from the government had accelerated. First, compared to 1984, capital construction in Xiamen from 1985 to 1989 consistently outpaced the growth of the government financial revenues (see Table 5-2.3).[10] As a result, the pressure exerted on the government finance is enormous, despite the fact that the government appropriations

[10]. Capital construction, mainly including the citywide infrastructure construction and technological innovation in existing enterprises, has always been the biggest spending item, accounting for more than half of the government expenditures.
Other main items are health care, culture, education, scientific researches, and governmental administration, etc..

normally accounted for only 50-60 percent of the total costs of capital construction. It was estimated that total costs during the period of 1985-90 would be ¥5 billion, but the government could only be able to provide ¥2 billion, thus leaving a gap of more than ¥3 billion (Research Office, 1989: 216).[11]

Second, additional pressure arose from some exceptional elements. Starting from 1986-87, Xiamen entered the peak period of debt repayment for the huge bank loans borrowed in early 1980s when the SEZ was created. In 1986 alone, for example, the total payment of interest and principle accounted for 38 percent of the government expenditure budget in the year (ibid: 211).

Third, the government had to pay a substantial amount of compensation to some overseas Chinese and Taiwanese for occupying their original premises in Xiamen, with an area of more than 200,000 sq metres being involved (He Lifeng, 1986).

In short, there was a big gap between what the government finance could offer and what the public projects demanded. Given the fact that the demand for big and key capital constructions --- deemed as crucial to the improvement of the SEZ's investment environment --- in Xiamen would remain strong until the early 1990s, the government finance is bound to have a very difficult time to come. "As the financial revenue is hard to increase sufficiently and the expenditures to reduce significantly in a short time," admitted by the authorities, "the government has no alternative but to exert a tight control over the public-owned enterprises and take away most of their profits" (Research Office, 1989: 211). That is why the Xiamen authorities were so reluctant to reduce the local enterprises' profit tax rate and the amount of profit deliveries.

As a result, the first wave of the enterprise reform, aimed at to restructuring the operational mechanism of

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[11]. Capital construction was also financed by bank loans, enterprise' self-raised funds, and foreign capital, etc., apart from the government appropriations.

enterprises by removing the price subsidies, failed to proceed further because of what the authorities described as "exceptionally severe financial difficulties."

5-3. Different Perceptions of the Problem

Faced with the setback of the enterprise reform in Xiamen, local academics and experts debated the problem from different perspectives and some of them even put forward their policy recommendations.

Three major arguments have emerged from the discussion. The first, represented chiefly by Mr. Guo Zheming, the director of the SEZ Research Institute of Xiamen University, and Mr. Luo Huiming, a deputy director of Fujian Centre of Economic Studies, attributes the problem to "the failure to fully make use of the Special Policy" granted by the central government (Guo Zheming, 1988; Luo Huiming, 1988). The second, contended mainly by Mr. Du Qiang, a research fellow of the SEZ Research Institute of Fujian Academy of Social Sciences, blames the problems squarely on "the established economic management system" (Du Qiang, 1988). The third, argued principally by Mr. Su Yanhang, the director of the SEZ Research Institute of Fujian Academy of Social Sciences, identifies the "lack of a coherent coordination between the development objective of the SEZ and the specific policy measures" as the prime reason (Su Yanhang, 1989).

The Xiamen SEZ authorities apparently agreed with much of the first and second views. The official book, *Xiamen Socio-Economic Development Strategies for 1985 - 2000*, clearly states that "the deep reason for failing to push the enterprise reform ahead lies in our established institutions and the failure to understand and utilise the Special Policy properly." It argues that "while on the whole following the general reform policy of the country, Xiamen should explore and open up its own way of reform by freeing itself from the constraints of the established system." "To achieve this," it goes on, "we must bring the existing Special Policy into full

play and ask the Centre, if necessary, to grant us more autonomy." "Only with an effective Special Policy," it concludes, "can the old and rigid system be smashed and a new and open one established" (Research Office, 1989: 127).

The central government seemed to accept the conclusion reached by the SEZ authorities. In early 1988, the SEZ was granted a provincial status in the national economic planning, i.e. Independent Planning. That is to say, the SEZ can now bypass the Fujian provincial government and negotiate directly with the central government in terms of financial and physical arrangements. This latest policy initiative taken by the Centre has undoubtedly given the SEZ a big push in its drive to restructure the enterprise management system. Soon, a new reform strategy, claimed to be "quite different from the national reform plan," was formulated and the second wave of the enterprise reform launched in the Xiamen SEZ.

5-4. The Second Wave of the Reform: the Separation of Tax and Profits.

The second wave of the enterprise reform was centred on a new idea --- the Separation of Tax and Profits (STP) (*Shuili Fenliu*). Like other SEZs and pilot cities in China, Xiamen has carried out some radical reforms in most of its COEs and some small-sized SOEs. By the end of 1989, a dozen enterprises had become joint-stock companies by issuing shares to their employees and the general public. Four small SOEs were converted into collective ownership. While eleven failing factories were either taken over by or merged with more dynamic local TVEs, seven profitable ones set up joint ventures with foreign investors. Some private individuals, both local and foreign, were reported to have taken over the management of several enterprises, mostly loss-making, through a variety of contractual agreements (*XMRB*, 8/9/91). But for the majority of SOEs which still constituted the backbone of Xiamen's economy, the STP scheme was their principal reform programme.

Background

As introduced in Chapter 2, prior to the present economic reform, a SOE in China was required to hand over all of its profits to the responsible government department, whether at the national or local level. Its capital expenditures in turn were approved and totally funded by the department. There was virtually no incentive to exceed production targets, since an efficient enterprise could find itself starved of capital while its profits were diverted to finance investment in a less successful enterprise. Thus profitable and unprofitable, efficient and inefficient enterprises were all "eating from the one big pot."

Before the mid-1980s, Xiamen basically followed the national reform policy in carrying out its enterprise reform.[12] In the late 1970s and early 1980s, a series of experiments were introduced, whereby the enterprise management was given greater control over production decisions once the basic production targets were fulfilled, and enterprises were allowed to retain a proportion of its profits in excess of "planned" profits, which were to be turned over to the state.

Later, an *Profit Tax* on the profits of all SOEs was introduced to replace profit delivery (*Li Gai Shui*). All enterprises keeping "independent economic accounts" were subject to the tax.[13] The rate of tax varied from enterprise to enterprise, being calculated according to complex formulae. In general, large- and medium-sized enterprises paid tax at a flat rate of 55 percent while small enterprises were taxed according to a progressive scale, beginning at 7 percent and

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[12]. The following information regarding the reform programmes implemented nationwide are based on Liu Suinian and Wu Quangan (1986), A.J. Easson (1990), Plasschaert (1990), and The Reform Centre (1989).

[13]. The Profit Tax is calculated annually on the basis of profits earned during the fiscal year, but is payable in advance on a daily, ten-daily or monthly basis. Normally it is paid to the local tax bureau of the Finance Department.

For more discussions of China's tax reform, especially the programme of *Li Gai Shui*, see Prime (1992).

rising to 55 percent (with an average rate of 40 percent) where annual profits exceed ¥80,000.[14]

At the same time, indirect taxation also underwent a radical reform. The previous *Industrial and Commercial Tax (Gongshang Shui)*, was replaced by three taxes:

1). *Product Tax (Chanpin Shui)*, payable by all enterprises engaged in the production or importation of taxable products and calculated on the basis of sale price at a rate ranging from 3 to 60 percent. It is China's chief economic regulator and hence the most important tax.

2). *Business Turnover Tax (Yingye Shui)*, payable by all units and individuals engaged in trades other than manufacturing industry.

3). *Value-added Tax (Zengzhi Shui)*, applicable only to a limited range of products, mainly manufactured goods.[15] This tax, which rates varying from 6 to 16 percent, was intended to avoid the cumulative effects of multi-stage turnover taxes and the distortions characteristic of a single stage tax imposed at the manufacturer level.

To reduce those profit disparities between enterprises which are the result of differences in physical conditions, a special *Regulatory Tax (Tiaojie Shui)* was applied to "unearned" profits made by some "well-endowed" enterprises. In addition, a *Resource Tax (Ziyuang Shui)* was levied as a form of excess profits tax on the exploitation of crude oil, natural gas and coal; an *Oil Burning Tax (Nanyou Shui)* was designed to encourage the use of coal instead of oil and to regulate the profits made by enterprises from using cheap oil. A *Land Use Tax (Yuangdi Shui)* was proposed to regulate differential incomes due to geographical location and to promote the economic use of land; and a *Bonus Tax (Jiangjing*

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[14]. Small enterprises are defined as those industrial enterprises whose fixed assets do not exceed ¥1,500,000 in value and whose annual profits do not exceed ¥200,000.

[15]. They include agricultural machinery, bearings, mechanical equipments, rolled steel, bicycles, cars, electric fans, and sewing machines, etc..

Shui) was introduced to deter the payment of excessive bonuses to employees.

Admittedly, the performance of most of the SOEs in Xiamen has somewhat improved because of those reform programmes, especially the substitution of tax for profit delivery. Data in Section 4-3 and this chapter have all suggested that industrial outputs, capital construction, the government revenues, and workers' earnings all increased appreciably since the introduction of the programmes

However, the tax-for-profits reform has failed to address the following issues:

First, the reform, though enhancing the government's role as a tax collector, neglected the government's right to receive profits made by SOEs. This has not only confused the government function of managing the economy with the ownership but also jeopardized the management of state assets.

Second, different rates of tax, applicable to different enterprises according to the type of ownership, have created inequality and unfairness among the enterprises in the SEZ. As described before, the foreign-involved and domestic-associated enterprises only paid 15 percent, plus various financial concessions in the light of the Special Policy, COEs and TVEs paid on average 40 percent, and the rest of enterprises, mostly SOEs, had to pay 55 percent, plus various regulatory taxes.

Third, under the reform, enterprises were still allowed to repay their loans for capital construction out of their pre-tax profits, and thereby the investment burden still fell on the shoulders of the state. As a result, the "hunger" for capital construction continued, and the economic efficiency of investment was hard to improve.

Fourth, because of the confusion and ambiguity of the new tax regulations, tax fraud took place in a large scale.

And finally, lack of coordination among other economic reforms, especially price reform, severely discounted the result of the tax reform.

Faced with these problems, the Xiamen authorities found

it hard to carry out the tax reform alone. Also, as discussed in Section 5-2, the reluctance of the authorities to cut the rate of profit tax of the local SOEs, due to the severe financial constraints, brought the enterprise reform in the SEZ to almost a standstill. At the same time, the enterprises, increasingly resenting their disadvantageous financial position, rushed to form economic associations with foreign or interior partner(s) in order to enjoy a lower tax rate (15 percent). This not only brought an unnecessary financial loss to the authorities, but also seriously disrupted the readjustment of industrial structure and the re-organisation of enterprises in the SEZ. Thus the severity of the problem forced the Xiamen authorities to find a new solution urgently.

Reform Policies and Changes

In 1988, the enterprise reform in China as a whole focused on implementing the CRS. The Xiamen authorities, on the other hand, decided to try out the scheme of STP in all enterprises within the government financial budget (*Yusuanlei Qiye*) in the SEZ.[16] With the approval of the State Council, the new scheme included: 1) cutting down the rate of profit tax from 55 to 15 percent; 2) abolishing the regulatory tax; 3) handing over after-tax-profits on a contract basis; and 4) repaying loans out of after-tax-profits, instead of pre-tax profits.

--- Cutting down the rate of profit tax. This means that there is only *one* unified rate of profit tax operating in the SEZ. In other words, *all* enterprises in the SEZ, regardless of the type of their ownership, are now paying the same rate of profit tax, i.e., 15 percent. At the same time, the regulatory tax was abolished. The authorities claimed that this was intended to "regularize the distributive relationship between the state and the SOE."

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[16]. The majority of enterprises in this category are SOEs. Later in the year 6 large SOEs in Shanghai also started experimenting this scheme.

--- Fixing the amount of after-tax-profits delivery on a basis of "one rate for one unit." Based on the amount of profits made in 1987, each enterprise hands the profits over at certain rate, ranging from 1 to 35 percent, with an average rate of 12 percent for the whole SEZ. This is designed to "regulate the difference in the after-tax-profits among SOEs."

--- Enterprises repay bank loans from after-tax, instead of pre-tax, profits. In addition, they are given freedom to decide when and how much they are to repay. As this change has shifted the financial burden of capital construction from the state to enterprises, it is hoped that it would harden the "budgetary constraint" on them.

As this new reform scheme implies a radical shake-up of the financial, fiscal and budgetary managements of the Xiamen government and the local enterprises, several important issues are inevitably raised:

First, is this new STP scheme better than the Tax-for-Profits programme or the CRS in serving the purposes of the enterprise reform?

Second, can the government financial revenue be guaranteed to grow in proportion to the growth of industrial production with this new arrangement?

Third, what rate of the after-tax-profit delivery is appropriate for enterprises?

Fourth, do enterprises have the ability to repay their loans and, at the same time, carry out all necessary internal investments out of their after-tax-profits?

Fifth, is this new reform plan conducive to the development of an export-led outward-looking economy in the SEZ?

And finally, is the system be transferable to the domestic enterprise reform?

Analyses of the Reform Performance

After two years of implementation of the STP scheme, the Xiamen authorities have surveyed 66 SOEs experimenting this

reform scheme and revealed the results (see Table 5-4.1).

Table 5-4.1 Changes in economic performances of 66 SOEs implementing the STP scheme (1987 - 1989) (million yuan, in current prices)

	1987	1988	1989	88/87 (%)	89/87 (%)
GVIO	1,049.2	1,196.8	1,264.7	114.1	120.5
Total profits	122.1	156.6	177.3	128.3	145.2
Sale taxes	84.9	102.8	72.1	121.1	84.9
Profit tax & delivery	48.1	43.9	49.8	91.3	103.5
Profits retained by enterprises	32.2	112.8	130.3	350.3	404.7
Loan Repayment	63.0	79.2	105.2	125.7	167.0
Welfare & Bonus Funds	----	-----	-----	164.7	107.0
Total Value of Fixed Assets	441.0	509.6	573.5	115.6	130.0

Sources: 1). *JJGZZYJZL*, 33/91, p. 12;
2). Welfare & bonus funds: *JJTZGG*, 4/90, p. 55.

As can be seen from the table, the GVIO, profits, total value of fixed assets, and loan repayment made by the enterprises grew steadily during the two years of the reform. The workers and staff's welfare and bonus funds also showed a big increase. The profits retained by the enterprises, in particular, was three to four times bigger than it was before the reform.

As to the drop of 15.1 percent in sale taxes in 1989, the authorities attributed it to the replacement of the product tax by the value added tax (Jiang and Lu, 1990: 55). Although the profit tax and deliveries suffered a significant fall in 1988, and failed to make any substantial increase (over 1987) in the following year, "the government financial revenue on balance actually increased," the authorities stressed, "because it saved more from expenditures than lost on revenues" (ibid).

Based on these achievements, the SEZ authorities claimed that the STP scheme had kept the revenues of the state, the enterprise and the individual "in balanced growth" and made the enterprise "accountable to its own operations." "It

represents a new relationships between the three parties and a new mode of enterprise management." Thus, they declared that "the reform had achieved success" (AXSEZ Editorial Board, 1991: 124).

However, if we widen the scope of survey to all SOEs implementing the scheme, extend the time period to five or more years, thus including the previous period of the Tax-for-Profits reform, and examine more economic indicators, a different picture will emerge.

As the enterprise reform is centred by the adjustment of the relationships between the state, the enterprise and the individual, our examination is to be conducted from these three perspectives.

Changes in the Government Revenues The government financial revenues in Xiamen, just like everywhere in China, consist of budgetary (*Yusuannei Shouru*) and non-budgetary (*Yusuanwei Shouru*) revenues. The former includes various tax revenues, profits and other payments delivered by enterprises (short for "enterprise deliveries"), and other revenues, accounting for 60-70 percent of the total revenues.[17] Likewise, the government financial expenditures are composed of budgetary (*Yusuannei Zhichu*) and non-budgetary expenditures (*Yusuanwei Zhichu*). The former contains funds of capital construction, technological innovation, and R and D in enterprises, making up 80-90 percent of the total expenditures.[18]

The essence of the STP scheme, in the context of the relationship between the state and the enterprise, is that the growth of the government financial revenues in proportion to that of industrial production should be guaranteed while

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[17]. While the latter contains revenues from SOEs and their responsible governmental departments, administrative establishments, and local financial departments, etc..

[18]. While the latter includes urban maintenance costs, R and D funds, and the payments of energy and transport funds, etc..

enterprises are allowed to pay less tax and retain more profits to finance their internal investments.

Table 5-4.2 Changes in the government financial revenues and expenditures in Xiamen (1981 - 1989)
(million yuan, in current prices)

	1981	1982	1983	1984	1985	1986	1987	1988	1989
Budgetary revenues	210.2	229.5	231.8	286.7	391.2	450.6	482.9	594.7	810.9
% over previous year	-----	109.2	101.0	123.7	136.4	115.2	107.2	123.2	136.3
Of which:									
Various tax revenues	138.0	150.2	166.6	204.6	315.5	362.6	400.3	500.7	727.4
% over previous year	-----	108.8	110.9	122.8	154.2	114.9	110.4	125.1	145.3
Enterprise deliveries	53.4	55.6	62.8	80.6	67.3	77.0	71.9	80.6	51.9
% over previous year	-----	104.1	112.9	128.3	83.5	114.4	93.4	112.1	64.4
Budgetary expenditures	75.2	93.8	117.0	140.9	291.2	375.9	352.9	433.4	695.4
% over previous year	-----	124.7	124.7	120.4	206.7	129.1	93.9	122.8	160.5
Of which:									
capital construction	-----	-----	-----	-----	113.7	135.9	110.4	107.4	178.6
% over previous year	-----	-----	-----	-----	-----	119.5	81.2	97.3	166.3
Tech. innovation	-----	-----	-----	-----	26.9	47.5	52.9	54.4	112.9
% over previous year	-----	-----	-----	-----	-----	176.6	111.4	102.3	207.5
R & D	-----	-----	-----	-----	4.6	6.1	5.1	7.4	8.6
% over previous year	-----	-----	-----	-----	-----	132.6	83.6	145.1	116.2

Note: ---- Data are not available.

Sources: 1). 1981-85: the AXSEZ Editorial Board (1986), p. 127;
2). 1986: XSB (1987), p. 363;
3). 1987: XSB (1988), p. 339;
4). 1988: XSB (1989), p. 377;
5). 1989: the AXSEZ Editorial Board (1990), p 168.

As revealed from Table 5-4.2, it is true that government financial revenue continued to grow during the two years of the reform, with annual growth of 23.2 percent for 1988 and 36.3 percent for 1989 (including inflationary factor). This was due almost entirely to the steep increase in the "various tax revenues" (25.1% in 1988 and 45.3% in 1989), resulting from the enhancement of the taxation policy brought about by the reform. These growth rates are relatively high, compared to those for the previous years, except that for 1985, when the reform of Tax-for-Profits was being implemented.

However, it is also clear from the table that the Xiamen authorities were still paying out for the capital constructions, technological innovations, and R and D of some enterprises, if not all or most, in 1988 and 1989, rather than cease the payment, as required by the reform. What is more,

the amounts they paid out in 1989 soared, growing by 66.3 percent for the capital construction, 107.5 percent for technological innovation, and 16.2 percent for R and D (including inflationary factor). In view of the essence of the reform, such an increase in the three expenditures, which were supposed to be financed by the enterprises themselves, is hardly justifiable.

This continuous and indeed increasing payment has a serious implication for the STP scheme. First, if we subtract the amounts of the three payments from the total government budgetary revenue, we find that the revenues for 1988 and 1989 were actually ¥425.5 million (= 594.7-107.4-54.4-7.4) and ¥510.8 million (=810.9-178.6-112.9-8.6), respectively. They are in fact only 88.1 percent and 105.8 percent of the 1987 level (¥482.9 million). This result is close to the findings in the survey of the "profit tax & delivery" of 66 SOEs in 1988 and 1989 (91.3% and 103.5%, see Table 5-4.1). It indicates that the survey results largely reflect the true state of the government finance in Xiamen, and thus cast doubt over the official claim that the reform has been largely successful.

Second, with the adjusted figures of the "budgetary revenues" for 1988 and 1989, Table 5-4.3 shows that the two years of the reform actually registered a marked decline in the growth rate of the government financial revenues in Xiamen, compared to the previous two reform periods (1981-85 and 1986-87). At the same time, the table also demonstrates that the growth of the financial revenue lagged far behind that of the industrial output value, with 88.1 and 105.8 percent against 110.3 and 122.8 percent, respectively.

All these indicate that the STP scheme has, at very least, failed to keep the growth of the government financial revenues in proportion to that of industrial production, as intended by the reform. Indeed, one local official disclosed that the average percentage of the government financial revenues in the total profits made by the enterprises dropped from 39 percent in 1987 to an average 28 percent in 1988 and

1989 (Liu Shuren, 1991: 5).

Table 5-4.3 The GVIO of all SOEs and adjusted budgetary revenue in Xiamen (1981-1989)
(million yuan, in 1980 prices)

	1981	1982	1983	1984	1985	1986	1987	1988	1989
GVIO	792.0	874.4	986.6	1,104.5	1,306.5	1,502.4	1,639.8	1,808.5	2,014.3
Growth rate (%)	-----	110.4	124.6	139.5 over 1981	165.0	115.0	125.5 over 1985	110.3	122.8 over 1987
Budgetary revenue	210.2	229.5	231.8	286.7	391.2	450.6	482.9	425.5	510.8
Growth rate (%)	-----	109.2	110.3	136.4 over 1981	186.1	115.2	123.4 over 1985	88.1	105.8 over 1987

Sources: 1). 1981-85: the AXSEZ Editorial Board (1986), p. 71;
2). 1986: XSB (1987), p. 32;
3). 1987: XSB (1988), p. 30;
4). 1988: XSB (1989), p. 32;
5). 1989: the AXSEZ Editorial Board (1990), p. 186.

Third, the fact that the state continued to put a large amount of funds into the enterprise internal investments clearly contradicts the principle of the reform, and hence raises several serious questions: why did the Xiamen authorities have to continue to invest in the enterprises under the reform? is the new after-tax-profit delivery rate appropriate for the self-development of the enterprises? and how could the authorities afford to lose the financial revenues in carrying on this "reform"?

Changes in the Enterprise Finance and Behaviour The STP scheme is designed to stimulate enterprises to increase their production and efficiency by hardening their "budgetary constraints." Table 5-4.4 reveals three important points. First, the reform has apparently accelerated the development of industrial production, with two consecutive higher growth rates (25.3% and 25.0%) of the net output value in 1988 and 1989. It has also fostered a strong and steady rise in export production, with growth rates being more than 30 percent for the same two years.

Table 5-4.4 Changes in key indicators of the SOEs in Xiamen (1985 ---- 1989)
(million yuan, in current prices)

	1985	1986	1987	1988	1989
Net Output Value	475.9	556.1	599.5	750.9	938.9
% over previous year	-----	116.9	107.8	125.3	125.0
Output value for exports	112.4	151.9	176.8	239.0	313.6
% over previous year	-----	135.1	116.4	135.2	131.2
Total taxes & profit deliveries payable	215.9	141.3	236.2	564.8	691.5
% over previous year	-----	65.4	167.2	239.1	122.4
Total taxes & profit deliveries paid	209.6	120.7	197.9	257.6	340.8
% over previous year	-----	57.6	164.0	130.2	132.3
% of completed payment	97.1	85.4	83.8	45.6	49.3
No.of loss-making firms	3	7	16	29	41
% over previous year	-----	233.3	228.6	181.3	141.4
Total amount of losses	0.5	3.0	9.3	23.1	57.6
% over previous year	-----	600.0	310.0	248.4	249.3
Profits retained	35.6	40.7	44.6	120.9	145.4
% over previous year	-----	114.3	109.6	271.1	120.3
Repayment of loans	29.6	37.4	65.3	83.4	112.7
% over previous year	-----	126.4	174.6	127.7	135.1
Value of fixed assets	551.9	766.3	1077.5	1178.3	2102.8
Annual increasing value	-----	214.4	311.2	100.8	924.5

Sources: 1). 1985: XSB (1986), pp. 76, 84, 85, 88 & 226;
2). 1986: XSB (1987), pp. 46, 47, 51 & 188;
3). 1987: XSB (1988), pp. 44, 45, 48, 49, 57 & 132;
4). 1988: XSB (1989), pp. 47, 48, 49, 53, 57 & 160;
5). 1989: the AXSEZ Editorial Board (1990). pp. 182, 183, 186 & 256.

Second, although the total amount of taxes and profit deliveries demanded by the state went up substantially in 1988 and 1989, the enterprises seemed to be increasingly unable to meet that demand. This led to a sharp decline in the percentage of completed payment, dropping from 83.8 percent in 1987 to 45.6 percent in 1988 and to 49.3 percent in 1989.

There might be two reasons for this large proportion of arrears: 1). some enterprises, particularly those inefficient or loss-making ones, were unable to pay; and 2). others might deliberately hold up part of their payments and divert the money to other purposes in their own benefits, now that they have freedom to choose when and how much to hand over their after-tax-profits.

It is clear from the table that the number of loss-making enterprises went up from 16 in 1987 to 29 in 1988 and to 41 in 1989, with total losses jumping from ¥9.3 million to ¥23.1 million and to ¥57.6 million, respectively. This shows that the reform did not help reduce but actually increased losses, which certainly were responsible, at least in part, for the large arrears.

Third, the table also reveals that the after-tax-profits retained by the enterprises soared from ¥44.6 million in 1987 to ¥120.9 million in 1988 and to ¥145.4 million in 1989, expanding by 171.1 percent in 1988 and 20.3 percent in 1989. A survey found that most enterprises in Xiamen tended to first consider their internal needs, such as repayment of loans and welfare funds, when deciding the distribution of the after-tax-profits, and put the least priority on the profit delivery to the state (Lin Zhengzhong, 1991: 11).

Table 5-4.4 shows that the enterprises spent most of their retained profits on repaying their loans (69.0% in 1988 and 77.5% in 1989). In order to get new loans from banks, the enterprises apparently put the repayment of old loans as their priority. This means that they had left little money for internal investments, such as capital construction, technological innovation, and R and D. As a result, the state had no alternative but to put a considerable part of the tax revenues and delivered profits back into them. From the increasing amounts of fixed assets (¥100.8 million in 1988 and ¥924.5 million in 1989), it is clear that such increasing scale certainly could not be met by the enterprises' retained profits.

In short, the STP scheme had enhanced the role of the government taxation policy through imposing a single, unified rate of profit tax, thus creating a fair environment of competition for all kinds of enterprises in the SEZ. Together with the strong and steady growth in export production, the reform has certainly promoted the development of an export-led outward-looking economy in the SEZ.

On the other hand, it instituted a complex and sometimes

confusing rate system for the after-tax-profit delivery, which could not be strictly enforced among the enterprises and thus enabled them to dodge the payment. The above analysis also proves that this rate system was somewhat inappropriate to the self-development of the enterprises, since it failed to give them adequate retained profits to make internal investments. As a result, "budgetary constraints" were not completely hardened --- the enterprises might have to repay the loans they had borrowed, but key internal investments were still paid by the state.

Changes in the Individual Remuneration and Performance

Under the STP scheme, an enterprise has the right to decide how much of its retained profits would be designated as the Welfare and Bonus Funds in order to provide an appropriate incentive for its workers and staff. Table 5-4.5 shows that the Funds for the enterprises in Xiamen went up steeply by 42.8 percent in 1988 and 73.8 percent in 1989 over the previous year. However, the labour productivity for the same period increased only by 20.7 and 13.3 percent, respectively. Clearly, this pay award was not linked with labour performance and hence unjustifiable.

Table 5-4.5 Changes in the welfare and bonus funds and labour productivity in Xiamen (1985-1989)
(¥10,000, in current prices)

	1985	1986	1987	1988	1989
Welfare & bonus funds	2,522	3,064	3,571	5,098	8,860
% over previous year	-----	121.5	116.5	142.8	173.8
Productivity (¥/person)	20,816	22,817	25,577	30,882	35,001
% over previous year	------	109.6	112.1	120.7	113.3

Sources: 1). 1985: XSB (1986), pp. 53 & 92;
2). 1986: XSB (1987), pp. 49 & 51;
3). 1987: XSB (1988), pp. 53 & 57;
4). 1988: XSB (1989), pp. 49 & 57;
5). 1989: the AXSEZ Editorial Board (1990), pp. 183 & 198.

An unduly high rise in the pay award is a typical characteristic of the "soft budgetary constraints," commonly

observed in the SOEs in socialist economies, and it would normally fuel inflation spiral. Unfortunately, this was exactly the case in Xiamen during the period of 1988-89.[19] Thus it once again proves that the reform has failed to harden the "budgetary constraints" on the local enterprises.

5-5. Conclusions

The STP programme is the latest attempt made by the Xiamen authorities to break the deadlock of the enterprise reform in the SEZ. It was designed to rejuvenate hundreds of inefficient local enterprises, particularly the SOEs, in order to build up a dynamic, export-oriented industry, central to the success of the SEZ. Based on the above analyses, several important conclusions can be drawn as follows:

First, in terms of the relationship between the state and the enterprise, the reform has not only failed to keep the state financial revenue growing in proportion to the industrial production, but also confused the ownership with the management function of government --- the very problem the Tax-for-Profits reform had failed to solve. Although the tax and profits were paid and delivered separately under the STP scheme, they eventually went to the same destination --- the local Finance Department, because there was no a special body in charge of state-owned assets to take the delivered profits. Consequently, the scheme could hardly be seen as a better alternative to the previous enterprise reform programmes.

Second, with regard to the restructuring of the internal operational mechanism of the local enterprises, the reform has enhanced the taxation policy but failed to set up an appropriate stimulative mechanism within them. Under the scheme, the rate of the after-tax-profit delivery is negotiated, on an *ad hoc* basis, between the state and the enterprises and hence subject to endless bargaining and various manipulations. The profitable enterprises generally

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[19]. For more about the inflation in Xiamen in 1988 and 1989, see Chapter 7.

had a higher rate to pay than the less profitable, while loss-making ones did not have to pay, in other words, the "ratchet effect" still existed.

Third, the rate of after-tax-profits was actually served as an "adjustment tax" to regulate "excess profits." In the absence of consistent price reform, such adjustment is certainly justifiable. But, apart from the high degree of subjectivism involved in fixing the rate for individual enterprises, there is the problem of the delivery being used to achieve a high degree of profit equalization among the SOEs *independent of their underlying performance*. This principle may be consistent with an egalitarian social philosophy, but it contradicts the principle of the market economy. Furthermore, the combination of enterprise "profit tax" and the delivery of after-tax-profits often made the enterprises not having adequate retained profits to carry out all necessary internal investments, as intended by the reform.

Fourth, the STP scheme, designed to provide positive incentives for the enterprises, was diluted by the lack of well-coordinated supports from other economic reforms, especially the price reform. The Xiamen authorities failed to understand that greater financial autonomy of enterprise would be ineffective unless the price system is rationalized and an appropriate balance between the central and local controls of revenues is established. The remark made by a World Bank study about the potential problems of granting financial autonomy to enterprises when other aspects of system reform lag behind seems relevant to the situation in Xiamen:

> "...inappropriate motivation and distorted prices may lead enterprise managers to make bad investment decisions, and profits intended for enterprise saving may be divided into bonus and benefits for workers" (World Bank, 1985: 146).

Thus, the price reform is essential to the success of the enterprise reform.[20] Though paying tax and delivering "excess

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[20]. For more discussions of the relationship between the two reforms, see Perkins (1992).

profits" may to some extent mitigate the effects of irrational pricing, it cannot in the long run be regarded as a substitute for price reform. Without price reform, the STP scheme in effect makes all rates of after-tax profit delivery negotiable, and hence *ad hoc*. Only after price distortions are removed, will enterprises no longer make excessive profits or be compelled to run at a loss because of the prices established for their products. Consequently, an unified tax rate would be truly appropriate and fair for all enterprises, and the rate of the after-tax-profit delivery could be simplified or even abolished since it would no longer be required to play a regulatory function. It is in this sense that the Xiamen authorities should continue to push the price reform ahead.

Fifth, the STP scheme is actually a converted form of the CRS, which is widely implemented in other parts of China, and thus represents a retreat from more radical reform plans, such as ownership reform and privatization. Like the reform in the China as a whole, the enterprise reform in Xiamen was intended to improve the performance of the SOEs by *restructuring*, i.e. by introducing a partial reform that falls short of ownership change. This clearly reflects the Chinese authorities' intention of keeping the big or key industrial enterprises in public ownership, while allowing the sale or liquidation of small or inefficient ones.

Experiences in many developing countries show that economic decentralization and privatization "ought to be employed in tandem wherever possible," though the former normally should precede the latter. A reform policy which does not lead to privatization "tend to be half-hearted" and cannot "generate the necessary competitive pressure" (Borrmann and Wolff, 1991: 105).[21] Also, lessons from the previous enterprise reforms in the formerly socialist economies suggest

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[21]. The same also applies to any privatization programme which is not supported by the further deepening of the decentralization, because the privatization programme "will soon become bogged down and may even be reversed at the earliest opportunity" (ibid).

that partial reforms aiming at restructuring operational mechanism, instead of ownership system, were insufficient to tackle the fundamental problems embedded in SOEs and produce enduring benefits.[22] Most of these countries are now opting for more radical measures, including privatization and liquidation (Lee and Nellis, 1990). Dong Fureng, in view of the Chinese experience, concludes that "ownership reform is essential if the shortcomings of SOEs are to be eliminated" (Dong, 1990: 67). Some Western observers echoed this view and warned the Chinese authorities of the "disastrous results" likely caused by "further decentralization without some ownership reforms designed to introduce real hard budget constraints" (Singh, 1992: xv). Thus, as long as the enterprise reform in Xiamen remains partial, the local SOEs can never be really revitalized and hence able to compete with the local private- and foreign-owned sectors, let alone to meet challenge from the international market.

And finally, the Special Policy has, to some extent, distorted the results of the STP scheme. Despite the marked drop in the growth of the financial revenue, the Xiamen government still claimed the success of the reform and showed no sign of worrying about the relative decline of its revenue. The reason for this is that Xiamen had won an important financial concession from the central government since it was granted the right of "Independent Planning" in 1988. Under this new arrangement, Xiamen is no longer responsible for financing the budget of the Fujian provincial government and thereby saved its annual contribution, which stood at ¥150 million in 1987. Thus, it was the Special Policy which had allowed the Xiamen authorities to carry out the STP scheme without necessarily increasing the government financial revenue.[23]

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[22]. For more about the reform in East Europe, see Brus and Laski (1989), Chapter 6 and 8, and Kornai (1990).

[23]. No wonder, as observed by Dr. Zhang Jun, that there is "a similarity" between SEZ firms enjoying "preferential treatment(s)" (i.e. the Special Policy) and those "facing

Clearly, this is not a real *reform* but *exploitation* of the Special Policy. In fact, the Xiamen authorities have exaggerated the achievement of the economic reform by attributing many effects of implementing the Special Policy to the reform. They seemed to be keener on implementing the Special Policy than on reforming the old economic system, because the former is easier to carry out and quicker to produce results than the latter. In other words, the authorities tended, intentionally or unintentionally, to *substitute* the real economic reform with the implementation of the Special Policy.

However, the Special Policy is basically designed to facilitate the reform and attract more foreign investments. It is vulnerable to the changes in domestic and world economic conditions. Also, it contains many distortions caused by the semi-reformed economic variables and hence is open to various forms of manipulation or abuse. That is why the Policy has long been criticised for being "volatile," "unpredictable" and "lack of transparency." Thus, as far as the relationship between the economic reform and the Special Policy is concerned, it is the confusion of the two, in particular the substitution of the former with the latter, which has led to the problem of policy inconsistency, ambiguity and unpredictability in the Xiamen SEZ.

Clearly, most SOEs in interior China cannot experiment such "radical" reform since the Special Policy is not operated in their regions. There is no way for them to have the rate of profit tax cut from 55 to 15 percent, as they are still by far the largest contributor to the revenue of the central and/or their local governments. This implies that the transferability of the Xiamen experience for promoting the enterprise reform in other parts of China is very limited, and this casts doubt over the effectiveness of the SEZ serving as a "laboratory" for the domestic economic reform.

'soft budgetary constraint(s)'" in the typical, prereform economic system. See Zhang (1993), p. 18.

CHAPTER 6

THE FOREIGN DIRECT INVESTMENT AND INDUSTRIAL TRANSFORMATION IN XIAMEN

Having examined the enterprise reform in Xiamen in the preceding chapter, we now turn to another important dimension of the industrial reform --- the utilization of FDI in connection with the transformation of the local industry. Like most EPZs around the world, Xiamen has always put the introduction of FDI at the heart of its development plans. It is the principal, if not only, way for the SEZ to obtain foreign capital, technology and equipment, management expertise, and the access to the international market.

On the other hand, like most Chinese industrial cities, Xiamen faces a daunting task to transform its outmoded and rundown industry in the process of introducing foreign capital. Indeed, restructuring the irrational industrial structure and rejuvenating the 588 old enterprises are essential to the development of a competitive and dynamic exporting industry in the SEZ.

As a result, Xiamen sets itself the unique and formidable mission of combining the central role of an EPZ with the primary task of industrial reform in a socialist economy, more specifically, combining the introduction of FDI with the transformation of the old, centrally planned industrial system. Experience in the EPZs which generally had no or little established industry, shows that FDI projects have been quite successful in creating jobs and exporting earnings for local people, but achieved little in facilitating the transfer of technology and management know-how, let alone helping transform local existing industry.

Thus, Xiamen's experiment with utilizing FDI is

unprecedented, challenging and for-reaching. The question is, Is Xiamen's attempt realistic and feasible? Will foreign investors be interested in helping rejuvenate the local industry? Are the Xiamen authorities able to devise a policy framework that will succeed in both encouraging a greater inflow of FDI and ensuring that it makes the maximum contribution to Xiamen's industrial transformation?

A new development in this issue is the growing involvement of Taiwan capital in Xiamen since the late 1980s.[1] Today, TDI has become a predominant foreign economic force in Xiamen and is playing a decisive role in shaping its future.

Inevitably, one must ask: Are there any similarities and differences between TDI and other FDI? What effects has TDI exerted on the Xiamen economy? and What implications does the involvement of TDI in Xiamen for the wider development of the economic cooperation between the PRC and Taiwan?

This study is, therefore, unique and important because it examines the new experiment being carried out in Xiamen. It should be of interest both to development economists who may want to find out how a developing country can transform its inefficient industry with the help of FDI, and to scholars of comparative economic systems who may look into the way of capitalism and socialism accommodating each other within a particular policy enclave. Of course, this chapter is of practical importance to foreign (including Taiwanese) businessmen who have invested or are planning to invest in Xiamen and, indeed, China as a whole, either in the short term or potentially for long-term development.

Thus, this chapter will start with an survey on the general characteristics of FDI in Xiamen in Section 6-1; Section 6-2 continues exploring the problems arising from the

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[1]. The term *Taiwan direct investment* (TDI) refers only to the form of Taiwan investment in the PRC, as opposed to another form of investment, *portfolio investment*. As Taiwan still bans direct business contacts with the mainland, all the cross-strait investments have so far been conducted on an *indirect* basis.

For technical reason, TDI is seen as a part of FDI in this thesis.

utilization of FDI in relation to the local industrial transformation; Section 6-3 turns to discuss the trend and special features of TDI in Xiamen; Section 6-4 analyses major effects of TDI on the Xiamen economy; and finally Section 6-5 ends this chapter with conclusions.

6-1. Characteristics of FDI Projects in Xiamen

Experience in many developing countries indicates that industrial transformation generally involves structural adjustment to the changing world economic environment, which may require not only substantial investment in new lines of production but also deep-going renovation of existing industries.[2] However, how to make use of FDI to transform local existing industry, especially Soviet-type industrial system, remains largely untried and hence represents a historic challenge to Xiamen.

The Xiamen authorities' have formulated a series of Special Policy improving Xiamen's investment environment, in order to attract more FDI projects (see Appendix E). Their policy and strategy for the local industrial transformation are:

> "... to rationalize the industrial structure and upgrade technology in enterprises through forging close economic and technological links between the local industry and FDI. As a SEZ, Xiamen should make maximum use of the Special Policy to introduce as many as possible advanced foreign technologies and management experiences. ... From the strategic point of view, electronics should be chosen as the leading sector because it not only represents the modern advanced technology but also has a great bearing on technological transformation in other sectors" (Research Office, 1989: 139).

The introduction of FDI in Xiamen started as soon as it was designated as a SEZ in the early 1980s. By the end of 1989, as shown in Table 6-1.1, Xiamen had concluded 679

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[2]. This is particularly true in the case of the four East Asian NICs. For their experiences, see James, *et al.*, (1987).

contracts covering the major forms of FDI --- JEVs, CMEs and WFOEs. These contracts committed foreign investors to make investments in cash (usually foreign exchange), equipment, machinery and technology totalling US$1,227.02 million. Of this amount, $350.88 had actually been delivered, resulting in 358 firms under operation.

Table 6-1.1 Development of FDI in Xiamen (1983 - 1989)
(US$ million)

	1983	1984	1985	1986	1987	1988	1989	Total
No. of contract signed	24	86	105	34	50	180	201	679
Annual growth rate(%)	--	258.33	22.09	-67.62	47.06	260.00	11.67	42.51[a]
Foreign pledged amount	37.15	149.67	242.02	27.59	56.71	155.64	514.49	1227.02
Annual growth rate(%)	----	302.88	61.70	-88.60	105.55	174.45	230.56	54.97[a]
Foreign invested amount	7.75	40.44	73.28	33.93	17.53	47.96	129.80	350.88
Annual growth rate(%)	----	421.81	81.21	-53.70	-48.33	173.59	170.64	59.95[a]
% of the pledged amount	20.86	27.02	30.28	122.98	30.91	30.81	25.23	28.60[b]
No. of operated projects[c]	<------	146	------>		150	183	263	358	358
Annual growth rate(%)	----------				2.74	22.00	43.72	36.12	25.14[a]

Notes: **a**. Average annual growth rate; **b**. Average share; **c**. This is an accumulated figure.

Sources: 1). 1983-85: the AXSEZ Editorial Board (1986), p. 92;
2). 1986-89: the AXSEZ Editorial Board (1990), p. 327.

From the provincial perspective, although taking only 25.55 percent of 2,658 contracts signed by Fujian with foreign investors, Xiamen had successfully attracted 57.17 percent of US$2,146.25 million of the total foreign commitments, and 46.64 percent of US$752.33 million of the actually invested amounts in Fujian from 1983 to 1989 (FSB, 1989: 364; 1990: 294). In other words, the average capitalization of the FDI projects in Xiamen (US$1.807 million per project) was 2.24 times higher than Fujian's average level (US$0.807 million per project).

From the national perspective, from 1983 to 1989 Xiamen's average annual growth rate for the number of contracts signed (42.51%) was lower than that for China as a whole (51.92%), but the rates for the total foreign commitments and the

actually invested amounts (54.97% and 59.95%) were higher than those for the whole nation (21.60% and 32.18%) (Table 6-1.1; SSB, 1990: 653).

Several basic characteristics have emerged from the development of FDI in Xiamen and may be highlighted as follows:

1. *Three-Stage Development* The introduction of FDI in Xiamen in the 1980s went through three different stages of development. As shown in Table 6-1.1, from 1983 to 1985 the size of FDI, both in terms of the number of contracts and foreign capital involved, increased steadily owing to the setting-up and then enlargement of the SEZ. During the period of 1986-87, however, the inflow of FDI dropped sharply because of the implementation of the austerity policy in the Chinese domestic economy to combat the rampant inflation. This indicates that the SEZ is very vulnerable to the cycle of the domestic economy.

From 1988 to 1989, Xiamen witnessed an explosive expansion of FDI, with the numbers of contracts concluded and put into operation, and the foreign committed and actually invested amounts all exceeding their totals for the previous 5 years (see Table 6-1.1).[3] This was caused largely by the sudden influx of TDI.

2. *Predominance of TDI* As described above, since 1988 Taiwan investors started "invading" Xiamen in growing numbers. In 1988, Taiwan investors contributed, for the first time, more than half of total foreign committed capital. By 1989, the number of TDI contracts accounted for over three-quarters of the total FDI contracts (see Table 6-3.1). This suggests that Taiwan capital will play a decisive role in shaping Xiamen's economic development in the future, just like the relationship between Hong Kong and the Shenzhen SEZ.[4]

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[3]. This contrasts sharply with the drastic decline in the general inflow of FDI in China as a whole in 1989, caused mainly by the Tiananmen Square Incident.

[4]. For more details of TDI in Xiamen, see Section 6-3 and 6-4.

3. *Domination of Manufacturing Investment* Unlike other SEZs, which have been criticised for attracting too many non-manufacturing investments, Xiamen, as an old industrial city itself, has introduced a large number of industrial manufacturing projects. Table 6-1.2 shows that over the period of 1980-89 the FDI in manufacture, both in terms of the number of contracts concluded and the amounts involved, accounted for 60-70 percent of total investments, indicating that Xiamen has a big potential to develop an export manufacturing industry.

Table 6-1.2 Composition of FDI in Xiamen by industry (1980 - 1989)

	No. of contracts	Share (%)	Pledged amounts (US$10,000)	Share (%)
Agriculture	36	5.33	3,649	2.97
Manufacture	478	70.71	73,783	60.13
Construction	21	3.11	637	0.52
Transportation	14	2.07	822	0.67
Commerce	28	4.14	1,247	1.02
Real estate	91	13.46	33,174	27.04
Others	8	1.18	9,390	7.65
Total	676	100.00	122,702	100.00

Source: the AXSEZ Editorial Board (1990), p. 329.

4. *An Important Manufacturing and Exporting Force* Table 6-1.3 reveals that, since 1982, the GVIO of FIEs (short for "fgvio") in Xiamen had been growing at an average growth rate of 11.56 percent per year (its annual growth rate short for "fgr"), raising its share in Xiamen's total GVIO (short for "TGVIO") from mere 1.28 percent in 1982 to 48.54 percent in 1989. On the hand, exports from FIEs grew even faster, at an average rate of 98.26 percent per year, pushing up their share from almost nothing (0.49%) in 1984 to well over a quarter (28.10%) in 1989. Judged by this trend, it is perfectly conceivable that FIEs will become a dominant manufacturing force and major exporter in Xiamen in next 2-3 years.

Table 6-1.3 Growth of GVIO and exports of FIEs in Xiamen (1981 - 1989)

	TGVIO	fgvio	fgr	Share	TEX	fex	fgr	Share
	(¥10,000, in 1980 prices)		(%)	(%)	(US$10,000)		(%)	(%)
1981	100,747	-----	----	----	13,112	--	----	----
1982	110,079	1,410	----	1.28	12,402	--	-----	----
1983	117,662	1,422	0.85	1.21	12,381	--	------	----
1984	147,547	7,541	430.31	5.11	15,584	77	-------	0.49
1985	214,070	40,461	436.55	18.90	16,527	1,817	2259.74	10.99
1986	246,864	43,521	7.56	17.63	16,374	1,516	-16.57	9.26
1987	328,566	97,901	124.95	29.80	26,107	4,184	175.99	16.03
1988	481,571	206,245	110.67	42.83	57,607	8,428	101.43	14.63
1989	550,998	267,443	29.67	48.54	64,678	18,176	115.66	28.10
Total	2,298,104	665,944	111.56[a]	28.98[b]	234,772	34,198	198.26[a]	14.57[b]

Notes: a. Average annual growth rate; b. Average share.

Sources: 1). GVIO: 1981-85: the AXSEZ Editorial Board (1986), p. 71;
1986: XSB (1987), p. 31;
1987: XSB (1988), pp. 29 & 92;
1988: XSB (1989), pp. 31 & 40;
1989: the AXSEZ Editorial Board (1990), pp. 173 & 179.
2). Exports: 1981-84: the AXSEZ Editorial Board (1986), p. 123;
1985-89: the AXSEZ Editorial Board (1990), p. 324.

6-2. Problems in Utilizing FDI to Transform the Local Industry

After several years of development, the industrial structure and enterprises in Xiamen have experienced a distinct change. However, they have also exhibited serious structural problems. Some of these problems were inherited from the old, centralized system, while others are new and resulted from the rapid expansion of FDI in the SEZ.

1. *Lack of Interdependence and Linkages between the Leading Sector and Other Sectors* Table 6-2.1 shows that when Xiamen was designated as a SEZ in the early 1980s there was no electronics industry at all. Instead, the food processing, chemical and pharmaceutical, machinery, and textile sectors formed the backbone of the local industry. By 1985, however, the electronics industry had become a predominant sector in terms of GVIO. By 1989, it had made up nearly 30 percent of Xiamen's total GVIO, almost 19 percent higher than its closest rival sector (chemical and pharmaceutical). Clearly, this

development trend seemed to be well in line with the official strategy.

Table 6-2.1 Growth and distribution of GVIO of the major industrial sectors in Xiamen (1981-1989) (million yuan, in 1980 prices)

	1981		1985		1986		1987		1988		1989	
	GVIO	%	GVIO	%	GVIO	%	GVIO	%	GVIO	%	GVIO	%
Electronics	0	0.00	440	20.65	449	18.77	861	27.00	1590	33.96	1616	29.33
Machinery	189	18.76	252	11.84	270	11.29	302	9.47	353	7.54	391	7.10
Food processing	265	26.30	238	11.17	259	10.83	289	9.06	347	7.41	449	8.15
Chemical & pharmaceut.	198	19.65	194	9.09	208	8.69	289	9.06	473	10.10	590	10.71
Textile	129	12.80	163	7.68	162	6.77	181	5.68	232	4.95	237	4.30
Rubber	21	2.08	101	4.74	122	5.10	132	4.14	135	2.88	162	2.94
Electric machinery	20	1.99	66	3.10	75	3.13	129	4.05	195	4.16	287	5.21
Building materials	37	3.67	64	2.69	64	2.68	71	2.23	93	1.99	107	1.94
Paper & stationery	7	0.69	43	2.00	52	2.17	75	2.35	97	2.07	109	1.98
Total	866	85.94	1561	72.96	1661	69.43	2329	73.04	3515	75.06	3948	71.66

Sources: 1). 1981: the AXSEZ Editorial Board (1986), p. 72;
2). 1985: XSB (1986), pp. 41-7;
3). 1986: XSB (1987), pp. 33-7;
4). 1987: XSB (1988), pp. 31-9;
5). 1988: XSB (1989), pp. 33-9;
6). 1989: the AXSEZ Editorial Board (1990), pp. 173-6.

Nevertheless, an examination of the breakdown of the GVIO of the electronics sector casts serious doubt upon the authorities' claim to succeed in developing the leading sector. Table 6-2.2 shows that consumer goods, composed of TV sets, radio cassettes and video recorders, took the lion's share of the total GVIO, ranging from 63 to 72 percent, while communication equipment, mainly comprising telephones and walkie talkies, accounted for only 22-30 percent. Together these two categories of products made up about 93 percent of the sector's GVIO for the period of 1987-89.

Table 6-2.2 Composition of the GVIO of the electronics industry in Xiamen (1987 - 1989)
(¥ 10,000, in 1980 prices)

	1987		1988		1989	
	GVIO	%	GVIO	%	GVIO	%
Consumer goods	54,386	63.14	113,542	71.42	109,196	67.57
Conmmuni. equip.	25,640	29.77	35,345	22.23	41,801	25.87
Component	5,774	6.70	8,894	5.59	8,738	5.41
Computer	22	0.03	1,008	0.63	1,404	0.87
Others	308	0.36	191	0.12	458	0.28
Total	86,129	100.00	158,981	100.00	161,597	100.00

Sources: 1). 1987: XSB (1988), p. 39;
2). 1988: XSB (1989), p. 39;
3). 1989: the AXSEZ Editorial Board (1990), p. 176.

What is more, these products, largely made of imported components and parts, were assembled mostly by FIEs in the SEZ, in other words, they have very low domestic value added. Table 6-2.3 shows that the imported contents of the total

Table 6-2.3 Shares of imported contents in total exports, and percentages of imports made by FIEs, in the electronics industry in Xiamen (1987 - 1989)
(US$10,000)

	1987	1988	1989
Total exports	3,874.67	6,332.62	7,874.09
Of which:			
Imported contents:	2,105.50	3,389.09	4,454.37
% of the total exports	54.34	53.52	56.57
Of which:			
by FIEs:	2,028.53	2,988.74	4,039.67
% of the imported contents:	96.34	88.19	90.69

Sources: 1). 1987: XSB (1988), pp. 331-2;
2). 1988: XSB (1989), pp. 373-4;
3). 1989: the AXSEZ Editorial Board (1990), pp. 90 & 325-6.

exports of the electronics industry during the period of 1987-89 reached around 55 percent. It also tells us that between 88

and 97 percent of the imports went to FIEs in the SEZ.[5] The reason for Xiamen to have such high rates of imported contents has been that many of its FIEs were wholly owned by foreign investors and engaged mainly in enclave export activities.

Experience in other developing countries suggests that it is vital for the success of export-led industrialization to develop at least one leading industrial sector, which is not only compatible with the dynamics of the world market, but also capable of generating growth of other sectors though extensive output-utilization (or forward linkage effects) and input-provision (or backward linkage effects) relationships (Meier, 1989: 283-8). Thus it is very hard to see how Xiamen's electronics sector, which mainly assembles consumer goods with imported components and parts and then exports most of its products, could have any significant linkage effects on other sectors.

2. *Lack of Breakthrough in Rationalizing the Local Industrial Structure* Despite the policy to make use of FDI to transform the local industrial structure, Xiamen has not made any significant progress in this direction. Table 6-2.1 might exhibit that the electronics industry was growing sharply and had become the leading sector, but Table 6-2.4, which divides GVIO of every sector into the local and foreign-involved parts (short for "local" and "foreign"), reveals a quite different picture.

We see that from 1987 to 1989 the local industrial structure remained relatively static, with machinery, food processing, chemical and pharmaceutical, and textile remaining as major sectors. That is to say, over the period of three years the various industrial sectors in Xiamen achieved a more or less proportionate growth or "a balanced development" --- a typical development pattern observed in the prereform China.

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[5]. An UNCTAD report, surveying 159 FIEs in Jamaica, Kenya, India, Iran, Colombia and Malaysia, shows that the percentage of imported contents in their total export sales ranged from 0 to over 60 percent, with an average level of 26.18 percent. See Streeten and Lall (1973), p. 9.

At the same time, the electronics industry, which had been designated as the leading sector, declined from 8.29 percent in 1987 to 5.35 percent in 1989, in contrast with its overwhelmingly dominant position on the foreign-involved side (76.81%).

Table 6-2.4 Xiamen's Total GVIO divided by the local and foreign-involved sectors (1987 - 1989)
(million yuan, in 1980 prices)

	1987					1988				
	TOTAL	local	%	foreign	%	TOTAL	local	%	foreign	%
Electronics	861	120	8.29	741	84.01	1,590	143	8.25	1,447	81.25
Machinery	302	300	20.73	2	0.23	353	327	18.86	26	1.46
Food processing	289	258	17.83	31	3.51	347	301	17.36	46	2.58
Chemical & pharm.	289	216	14.92	73	8.28	473	321	18.51	152	8.53
Textile	181	170	11.75	11	1.25	232	190	10.96	42	2.36
Rubber	132	123	8.50	9	1.02	135	118	6.81	17	0.95
Electric Machinery	129	127	8.78	2	0.23	195	170	9.80	25	1.40
Building materials	71	67	4.63	4	0.45	93	75	4.33	18	1.01
Paper & stationery	75	66	4.56	9	1.02	97	89	5.13	8	0.45
Total	2,329	1,447	100.00	882	100.00	3,515	1,734	100.00	1,781	100.00

	1989				
	TOTAL	local	%	foreign	%
Electronics	1,616	106	5.35	1,510	76.81
Machinery	391	355	17.91	36	1.83
Food processing	449	365	18.42	84	4.27
Chemical & pharm.	590	423	21.34	167	8.49
Textile	237	206	10.39	31	1.58
Rubber	162	132	6.66	30	1.53
Electric machinery	287	192	9.69	95	4.83
Building materials	107	101	5.10	6	0.31
Paper & stationery	109	102	5.15	7	0.36
Total	3,948	1,982	100.00	1,966	100.00

Sources: 1). Total GVIO: Table 6-2.1;
2). Foreign-involved GVIO: 1987: XSB (1988), pp. 92-3;
1988: XSB (1989), pp. 40-1;
1989: the AXSEZ Editorial Board (1990), pp. 179-80;
3). Local GVIO: deducting the foreign-involved GVIO from the total GVIO.

According to the linkage theory, it is crucial for a developing country at the initial stage of industrialization

to follow a policy of unbalanced investment and thereby create strategic imbalances that would set up stimuli and pressures that are needed to induce investments elsewhere in the economy. "If the economy is to be kept moving ahead," pointed out Albert O. Hirschman, "the task of development policy is to maintain tensions, disproportions, and disequilibria" (Hirschman, 1958: 66). In the context of utilizing FDI, this important issue has becomes how, after determining the proper sequence of investment decisions, to channel foreign capital into the leading sector(s) in order to help create the proper amounts of imbalance in the right activities.

However, judging by Table 6-2.4, there was no obvious sign of the "imbalance development" or breakthrough appearing in the local industrial structure, nor was there any evidence of the linkages between the local electronics industry and FDI.

3. *Lack of Linkage Effects between Manufacturing/ Processing Industries and Basic Industries* An examination of the growth rate of key industrial products in Xiamen over the period of 1981-89 reveals that those growing less than 100 percent or even negatively were important raw materials, mostly produced by local, indigenous industries, while those expanding over 100 percent or even 9,000 percent were light industrial products, largely manufactured, processed or assembled by newly emerged FIEs (see Table 6-2.5).

At the same time, the authorities also disclosed that from 1985 to 1989 transport capacity grew only by 7.2 percent; posts and telecommunications by 3.0 percent; and distribution, warehousing and storage facilities by 4.1 percent. Among the 45 large- and medium-sized enterprises in 1989, only 6 generated power or produced raw materials and their output value (¥188 million) made up only 6.31 percent of the total GVIO of the 45 enterprises. The other 39 were all manufacturing enterprises and their output value, ¥2.792 billion, accounted for 93.69 percent of the total GVIO (Wang Yong and Guo Jiuqiang, 1990: 21).

Table 6-2.5 Growth rates for some key industrial products in Xiamen (1989 over 1981)

Product (unit)	1981		1989	G.R. (%)
Electricity (100 m w/hr.)	30,745		25,082	-18.42
Steel ingot (ton)	4,200	(1985)	3,752	-10.67
Steel product (ton)	1,776	(1985)	2,516	41.67
Forging equipment (set)	2,346		2,201	-6.18
Ball bearing (10,000 set)	190		351	84.74
Raw salt (10,000 ton)	14		12	-14.29
Sulphuric acid (ton)	16,000		31,600	97.50
Caustic soda (ton)	5,251		8,146	55.13
Cloth (10,000 metre)	3,218		3,216	-0.06
Television (set)	6,000		570,200	9,403.33
Radio cassette (set)	1,000		673,200	67,220.00
Telephone (10,000 set)	20	(1985)	134	570.00
Washing machine (set)	167	(1985)	732	338.32
Bicycle (set)	51,000		248,900	388.04
Refrigerator (set)	118	(1985)	776	557.63
Canned foods (ton)	13,000		35,362	172.02
Beverage (ton)	6,000		42,540	609.00
Cigarette(10,000 box)	13		34	161.54

Sources: 1). 1981: the AXSEZ Editorial Board (1986), pp. 73-4;
2). 1985: XSB (1986), pp. 72-7;
3). 1989: the AXSEZ Editorial Board (1990), pp. 44-7.

Thus it becomes clear that the stimulus generated from the fast growing manufacturing/processing/assembling industries has not been transmitted to the stagnant or even declining basic industries, in other words, the "spill-over" effects created by the foreign-transplanted sectors has not reached to the local, indigenous ones. Indeed, Table 6-2.5, together with other previous tables in this section, indicates that the development of FDI in Xiamen has basically been of the enclave-type and therefore had little linkage effect on the local industry as a whole.

The reasons for the lack of the linkages are not difficult to find. About 95 percent of the raw materials needed by those manufacturing industries came from outside Xiamen, mostly abroad (Du Qiang, 1988). What really worried the Xiamen authorities was the increasing trend of importing

raw materials, instead of buying local inputs.[6] This has not only diminished or even eliminated linkage effects, as analyzed above, but also eaten up a great amount of foreign exchange, exacerbating the shortage of foreign exchange in the SEZ. As a result, the process of importing technologies and equipment to renovate the old enterprises in the SEZ has been retarded or obstructed.

4. *Predominance of Small-Sized Enterprises* In spite of the enormous effort made by the authorities to attract big FDI projects, particularly those from Western multinationals, small projects still accounted for nearly 95 percent of all FIEs in Xiamen by 1989 (see Table 6-2.6). This means that FIEs in Xiamen still has a long way to go to exploit economies of scale in the wider export market, which is crucial to the success of export-led industrialization.[7]

Table 6-2.6 Distribution of FIEs in Xiamen by size (1985 - 89)

	1985		1986		1987		1988		1989	
Size	No.	%	No.	%	No.	%	No.	%	No.	%
Large	4	0.65	7	1.12	9	1.33	9	1.22	12	1.46
Medium	12	1.95	13	2.08	31	4.57	33	4.48	33	4.00
Small	600	97.40	604	96.80	638	94.10	695	94.30	779	94.54
Total	616	100.00	624	100.00	678	100.00	737	100.00	824	100.00

Sources: 1). 1985: XSB (1986), p. 40;
2). 1986: XSB (1987), p. 33;
3). 1987: XSB (1988), p. 31;
4). 1988: XSB (1989), p. 33;
5). 1989: the AXSEZ Editorial Board (1990), p. 173.

5. *Upsurge of WFOEs* Table 6-2.7 shows that the share of WFOEs in the total number of signed contracts rose steadily

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[6]. In his speech to the international seminar held in Xiamen in September 1991, Mr. Wu Yongchun, the director of Xiamen Economic Information Centre, disclosed that only a few FIEs in Xiamen purchased limited amounts of local raw materials.

[7]. For more about the importance of gaining economies of scale for export-led industrialization, see James (1987), pp. 31-4 and Meier (1989), pp. 254-62.

from 6.58 percent in 1985 to 67.66 percent in 1989. This large swing to WFOE was due largely to the sudden influx of Taiwan firms since 1988.

Table 6-2.7 Composition of FDI contracts signed in Xiamen by type of investment (1985 - 1989)

	1985		1986		1987		1988		1989	
	No.	%	No.	%	No.	%	No.	%	No.	%
WFOE	10	6.58	5	14.71	13	26.00	79	43.89	136	67.66
JEV	103	67.76	26	76.47	31	62.00	87	48.33	55	27.36
CME	39	25.66	3	8.82	6	12.00	14	7.78	10	4.98
Total	152	100.00	34	100.00	50	100.00	180	100.00	201	100.00

Source: the AXSEZ Editorial Board (1990), p. 328.

On the other hand, WFOEs had a relatively poor record in implementing contracts. Only 38.54 percent of the signed projects (153 out of 397) had gone into operation by August 1990, in comparison with 60.92 percent for JEVs and 61.40 percent for CMEs at the same time. Likewise, only 12.98 percent of the agreed investment amounts (US$120 million out of US$928 million) had actually been contributed by WFOEs, in contrast to 44.94 percent for JEVs and 22.89 percent for CMEs. What is more, a considerable number of WFOEs were found to be engaged in "transfer pricing" practice (Zhang Fenqing, 1991: 27-8).

6. *Poor Performance in Importing and Utilizing Foreign Technology* There were some problems in selecting sectoral priority for importing foreign technology. From 1984 to 1989, about 60 percent of the total imported technologies went to the light industry, 12 percent to the chemical and pharmaceutical industry, 10 percent to the textile industry, and only 2.3 percent to the machinery industry (Li Wei, 1990: 32).

The machinery sector has traditionally been seen as the cornerstone of any manufacturing industry and played a key

role in the technological transformation and indeed industrialization of many economies. According to the 1985 Industrial Survey, the machinery industry in Xiamen could greatly expedite the transformation in other sectors if it could make an improvement in the technologies of hydraulic power, gear forming, design, and precision manufacturing (Research Office, 1989: 147). However, the machinery sector received less advanced foreign technology than other sectors, and thus the prospects of the technological progress in Xiamen remain in doubt.

In addition, the Xiamen authorities has been seriously concerned over the bias in the introduction of foreign technology towards hardware. For example, among the 375 items imported by Xiamen in 1988, 130 were assembly lines, accounting for nearly 35 percent, 223 were complete units and equipment, making up nearly 60 percent, and only 21, or 5.6 percent, were software or know-hows. The reason for this preference of hardware to software was that many end users believed that the former tend to be easier and quicker than the latter to increase production and hence economic benefits for them (Li Wei, 1990: 34).

As a result, few attempts have been made to study and digest the imported technologies thoroughly and indeed to modify them in the light of the local conditions. Without doubt, if modern technologies designed in the West are transferred to developing countries without a proper beforehand study and subsequent modification, it would lead to serious "distortions and inefficiencies" in recipient countries" (Stewart, 1977: 3).

Thus it is not surprising to learn that with nearly US$85 million being spent on importing some 2,000 items of "advanced foreign technology" from 1982 to 1988, only US$9 million returns had been generated (Li Wei, 1990: 35). This is largely in line with the estimation made by the Xiamen Statistics Bureau that for every US$100 spent on "technological innovation" only US$10.8 had been recovered (AXSEZ Editorial Board, 1986: 257).

As a result of the above problems in the industrial transformation, the gap of economic efficiency between the local and foreign-involved sectors has become increasingly bigger. Table 6-2.8 reveals the changes in the productivity between the two sectors from 1985 to 1989. Despite the steady growth achieved by the local side, its average annual growth rate was only 11.52 percent, more than 5 percent lower than that of its foreign rival. Consequently, the gap of productivity between them went up from ¥33,657 per person in 1985 to ¥65,583 per person in 1989.

Table 6-2.8 Changes in productivity between the local and foreign-involved industrial sectors in Xiamen (1985 - 1989)
(yuan/person, in 1980 prices)

	Local sector		Foreign-involved sector	
	Productivity	Annual growth rate (%)	Productivity	Annual growth rate (%)
1985	14,954	-----	48,611	------
1986	16,263	8.75	51,697	6.35
1987	18,324	12.67	75,473	45.99
1988	21,492	17.29	82,083	8.76
1989	23,132	7.63	88,715	8.07
Average	------	11.52	------	16.23

Sources: 1). 1985: XSB (1986), pp. 53, 65 & 69;
2). 1986: XSB (1987), pp. 51, 59 & 79;
3). 1987: XSB (1988), pp. 57, 61 & 77;
4). 1988: XSB (1989), pp. 48, 65 & 81;
5). 1989: the AXSEZ Editorial Board (1990), pp. 182, 198-9 & 336.

At the same time, profits and taxes per capita in the state-owned sector dropped from ¥12,400 in 1987 to ¥10,900 in 1989, the ratio of profits and taxes to GVIO from 22.83 percent to 19.28 percent, and the ratio of profits and taxes to capital from 38.32 percent to 21.86 percent. On the other hand, the same three indicators for the foreign-involved sector over the same period showed a growth in different degree, with the first increasing from ¥37,000 to ¥49, 500, the second from 23.11 percent to 24.89 percent, and the third

from 22.54 percent to 23.60 percent (Wang Yong and Guo Jiuqing, 1990: 30).

6-3. Trend and Special Features of Taiwan Direct Investment in Xiamen

The upsurge of TDI has been one of the most prominent developments in the PRC foreign economic scene in recent years. By the first quarter 1992, a total of 3,914 contracts had been concluded, calling for Taiwan commitments more than US$3.7 billion. Of this total, nearly 26 percent, or US$950 million, had actually been invested (*JJRB*, 17/6/92: 4). In 1991 alone, Taiwan capital accounted for 13.37 percent of total FDI projects in China, 11.59 percent of total foreign commitments and 10.68 percent of total foreign invested capital (*GJMY*, 5/92: 60). As a result, Taiwan has now surpassed Japan and the U.S.A. and become the second largest investor (only behind Hong Kong) in the PRC.

Most TDI projects are concentrated in the southeastern coastal areas, with Fujian province accounting for about three-quarters of the total. The Xiamen SEZ, with its unique and close links to Taiwan, has emerged as the frontrunner in attracting Taiwan capital in the country, accounting for approximately a fifth of total projects and half of total pledged and invested capital (*BR*, Jan.27-Feb.2,92: 17). The SEZ authorities have made the use of TDI to transform their old industries as the top priority of industrial development. According to Xiamen's Eighth FYP (1991-95), Taiwan firms will contribute almost 55 percent (or ¥12 billion) of total GNP (¥22 billion) by 1995 (ibid: 18).

Some Western observers have noticed that important development and are aware of the profound implication of it [e.g. Crane (1992): 842; Frankenstein (1992): 881], but none of them has done any serious research on it. Thus, the following two sections are devoted to a detailed analysis of the characteristics and effects of TDI in Xiamen, while the implication of TDI on the future development of Xiamen and

indeed the Chinese economy as a whole will be discussed in the concluding chapter.

It must be pointed out, however, that research on TDI in Xiamen (and indeed the whole PRC) is handicapped by two difficulties. First, TDI data are generally scare and unreliable due to two facts: 1). the large-scale inflow of TDI into China only has a relatively short history, and 2). many TDI projects are small and scattered, and were conducted either on an indirect base or secretly. Thus, in order to cover sufficient observations and data the examination period for TDI will extend to the early 1990s. And second, changes in the policies and measures of the PRC and Taiwanese authorities are so frequent and rapid that research is often outdated before publication. However, these problems are certainly not sufficient to undermine the validity and relevance of the arguments made and the broad conclusions reached in this thesis.

Trend

The first Taiwan investor, disguised as a businessman from a third territory, arrived in Xiamen in May 1983 and set up the first Taiwan-invested enterprise in the following year. Since then, the development of TDI in the SEZ has undergone three different phases. As can be seen from Table 6-3.1, between 1983 and 1987 only 16 contracts were signed and US$21.5 million committed, accounting for a mere 5.42 percent of total FDI projects and 4.19 percent of total foreign pledged capital over the same period.

The situation changed dramatically in 1988. The political relaxation in Taiwan and, in particular, the removal of the ban on its private citizens to travel to the mainland, triggered off a steady stream of visitors to the PRC, especially to Xiamen.[8] Many visitors combined private visits with a search for business opportunity. In response to this

[8]. It was estimated that the number of Taiwan visitors to Xiamen had well exceeded 1.2 million by the end of 1991.

new development, the Xiamen authorities, apart from promulgating a series of laws, regulations and rules to encourage TDI, opened up two investment zones (*Haicang* and *Xinglin*) and one high-tech park (*Yazhou*) exclusively for the Taiwanese. As a result, the inflow of TDI grew at a staggering speed. The total annual committed amount peaked in 1989 (US$454.15 million) and the number of projects in 1990 (172). More significantly, in 1989 TDI projects accounted for 76.62 percent of all FDI projects and 87.06 percent of all foreign committed capital in Xiamen.

Table 6-3.1 Development of Taiwan investment in Xiamen (1983 - September 1992)

	1983-87	1988	1989	1990	1991	1992 (Jan-Sept)	Total
No. of contracts signed	16	57	154	172	94	105	598
% of total FDI contracts	5.42	31.67	76.62	65.65	44.13	39.92	42.29
Capital committed by the Taiwanese (US$ m.)	21.50	82.19	454.15	370.00	195.68	204.21	1,327.73
% of total foreign commitments	4.19	52.80	87.06	67.40	37.65	27.73	44.25

Sources: 1). 1983-87: *XMTJ*, 8/1990, p. 23;
2). 1988: XSB (1989), p. 362;
3). 1989: the AXSEZ Editorial Board (1990), p. 329;
4). 1990: the ACE Editorial Board (1991), p. IV-89;
5). 1991-Sept.92: XSB (1992), p. 13.

From 1991 the influx of TDI dwindled sharply, with both the number of contracts and the amount of capital inflow in 1991 dropping by more than 45 percent over 1990. In the first nine months of 1992, the situation only showed a slight improvement. The local authorities blamed the decline on the opening-up of more areas in the country for the Taiwanese, while many foreign observers attributed it mainly to the relatively poor transportation links in Xiamen (*CBTR*, 1/92: 14).

Despite this setback, Xiamen still has the highest density of TDI projects in the country. Today, Taiwan firms are playing an increasingly important role in the development of export-oriented economy in Xiamen, with more than US$300 million being invested and over 200 projects under operation.

These projects produced about one-fifth of the SEZ's GVIO and nearly 15 percent of total exports (*JJRB*, 8/1/92: 4).

Motives

The following are the major reasons for the recent upsurge of Taiwan capital inflow to the PRC. First and foremost, the consistent and steady appreciation of the New Taiwan dollar (NT$) over the last decade has seriously weakened Taiwan's export competitiveness. Since 1985 the NT$ has appreciated by more than 40 percent against US$ to the ration of NT$25 to $1 at the mid-1992 (*FCJ*, 18/8/92: 3).[9] As the majority of exporters in Taiwan are small and medium manufacturing firms, operating in highly competitive conditions, the rise of the NT$ has left them unprofitable or, at best, only marginally profitable.

Second, other production costs have also risen sharply in recent years. The wages have been increasing by about 15 percent per annum, pushing the latest minimum wage up to NT$12,365 (US$494.6) per month, equivalent to NT$51.5 (US$2.06) per hour (ibid). This rate, which applies to both native and foreign workers in Taiwan, is about 13-14 times higher than that prevailing in most parts of the PRC.[10] Rising land costs add another problem and pollution-control expenses have also gone up steeply (*FCR*, 6/90: 60). These rises of costs have made the manufacture of labour-intensive products no longer competitive. "To beat competition from producers in

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[9]. According to Osman Tseng, there are four reasons for the continued appreciation. The large surplus generated by Taiwan's foreign trade, its extraordinarily large sums of foreign exchange reserves, and its higher interest rates have all created a growing demand for the NT$. Also, the economic recession in the U. S. has weakened the US$ and thus further raised the NT$. For more details, see Tseng (1992).

[10]. The average wage in the mainland is only about one tenth of that prevailing in Taiwan. For a typical Taiwan operation in the mainland, wages account for about 11% of the total production costs while in Taiwan it is about 36%. See *JJDB*, 9/3/92, (No. 9), p 33.

South Korea and Japan," said Mr. Wang Yung-ching, the Chairman of Taiwan's leading multinational corporation, the Formosa Plastic Group (FPG), Taiwan's industry "urgently needs to exploit the mainland's cheap labour" (*FCJ*, 6/10/92: 7).

Third, social order in Taiwan in recent years has seriously deteriorated. Violent political demonstrations, various forms of public disorder and, especially, gangland extortion of businessmen by threats of kidnapping or other criminal actions, had all undermined businessmen' confidence in the local investment environment (ibid).

Fourth, many Taiwan firms are using FDI to expand their exports in the mainland market, potentially the largest one in the world. Expressing the general mood of the Taiwan business community, Mr. Wang Chien-shien, Taiwan's then Finance Minister, was quoted as saying: "the mainland is a market for the Chinese people, and the Chinese people from Taiwan should not lag behind Japanese and Koreans in penetrating the mainland market" (*FCJ*, 18/8/92: 3).

And finally, in industries subject to heavy international restrictions, some Taiwan businessmen try to make use of PRC export quotas, especially to the North American and EEC markets (*YJ*, 5/92: 47).[11]

Special Features

The basic pattern of TDI in Xiamen is that investors provide capital, technology and management expertise, while Xiamen supplies cheap and abundant labour and land. However, in contrast to other foreign investors in Xiamen, the Taiwanese prefer wholly owned ventures to other forms of investment and, in many cases, emphasize their independence by supplying their own raw materials and export markets. Local people describe such operation as "designing in Taiwan,

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[11]. According to a survey report published in Taiwan in 1992, the export prices for the products manufactured by the Taiwan firms in the mainland, i.e. those "made in China," are estimated to be 10 percent cheaper than those "made in Taiwan." See *YJ*, 5/92, p. 44.

manufacturing in Xiamen, transshipping via Hong Kong, and selling abroad." Let us examine these features in greater detail:

1. *Predominance of Wholly Owned Enterprises* There is a growing tendency for Taiwan investors to set up wholly owned enterprises in Xiamen, instead of JEVs or CMEs. Table 6-3.2 shows that the share of wholly owned venture in the total number of Taiwan firms climbed steeply, from 37.50 percent in the period of 1983-87 to 85.47 percent in 1990, with an average percentage of 77.52 for the whole period of 1983-91. Investment in wholly owned ventures amounted to nearly US$1 billion, making up 90 percent of the total TDI in Xiamen (*BR*, Jan.27-Feb.2,92: 17). Such a high proportion of wholly owned venture is unusual in the history of FDI in developing countries.

Table 6-3.2 Shares of wholly owned ventures in the total number of Taiwan firms in Xiamen (1983 - 1991)

	1983-87	1988	1989	1990	1991 (Jan-Nov)	Total
No. of wholly owned enterprises	6	32	125	147	59	369
Total No. of Taiwan firms	16	57	154	172	77	476
Share (%)	37.50	56.14	81.17	85.47	76.62	77.52

Sources: 1). No. of wholly owned ventures: *XMTJ*, 8/1990, p. 26 and *JJRB*, 8/1/92, p. 4;
2). Total No. of Taiwan firms: Table 6-3.1.

2. *Predominance of Labour-Intensive, Light Industries* Because most Taiwan investors go to the mainland to take advantage of the low labour costs there, the industries they bring in tend to be those producing light industrial/consumer goods, with low capital/technology:labour ratios. About 75 percent of Taiwan firms in Xiamen used only simple and, in many cases, second-handed machines imported from Taiwan, manufacturing goods such as footwear, clothing, toys, umbrellas, handicrafts, luggage and sports equipment (*XMTJ*,

1990: 25). Indeed, some Taiwan firms even used less capital per unit of labour than the local state-owned counterparts.[12]

3. *Prominence of Chemical Industry* Relocation is crucial for Taiwan chemical manufacturers to survive because many of their end-product customers have moved to the PRC.[13] Thus it is not surprising that Xiamen, as the focus of TDI in the mainland, have a heavy presence of chemical projects, mainly including plastics and textile processing branches. As shown in Table 6-3.3, although they made up only 17.27 percent of all Taiwan manufacturing projects in Xiamen in 1990, the amount involved (US$284.70 million) accounted for a remarkable 48.76 percent --- nearly 37 percent ahead of its closest rival (the paper & stationery industry). At the beginning of 1992, that percentage still remained at 40 percent (*BR*, Jan.27-Feb.2,92: 18).

Table 6-3.3. Composition of Taiwan firms in Xiamen by industry (1990)

	No. of projects	%	Amounts involved (US$ million)	%
Chemical	48	17.27	284.70	48.76
Paper & stationery	67	24.10	69.44	11.89
Sewing & leather	49	17.63	66.88	11.45
Electric machinery	26	9.35	61.89	10.60
Textile	21	7.55	38.41	6.58
Building material	23	8.27	30.03	5.14
Food processing	20	7.19	13.37	2.29
Electronics	10	3.60	10.91	1.87
Machinery	14	5.04	8.25	1.41
Total	278	100.00	583.88	100.00

Source: *XMTJ*, 8/1990, p. 24.

[12]. One of the findings of the field survey in Autumn 1991. This is particularly true in the umbrella and luggage manufacturing.

[13]. The plastic footwear industry is a good example. The total number of factories in Taiwan dropped from 1,400 at the height time to only 700 in 1990, primarily because they had moved to the mainland. See *FCR*, 6/1990, p. 60.

4. *High Ratio of Export* As most of Taiwan firms' finished goods are placed by their parent corporations in Taiwan, they tend to have very high ratios of export.[14] For example, in 1990 Taiwan firms exported 86.12 percent of their total output valued at ¥799.83 million, in contrast with only 35 percent for non-Taiwanese FDI firms in the same period (Kong, 1991: 34). The exports from Taiwan firms accounted for 22.65 percent of Xiamen's total exports. About three-quarters of the exports went to Europe and North America and 10 percent to Japan (AXSEZ Editorial Board, 1991: 58). A survey carried out in 183 Taiwan firms in 1990 reveals that 107 (or 58.47%) of them exported more than 80 percent of their outputs, and that only 8 (or 4.37%) of them exported less than the half (see Table 6-3.4).

Table 6-3.4. Composition of Taiwan firms in Xiamen by export ratio (1990)

Export ratio (%)	Number of firms	Share (%)
100	56	30.60
80 - 99	51	27.87
50 - 79	68	37.16
Below 49	8	4.37
Total	183	100.00

Source: Hu Peizhao *et al.*, (1990), p. 16.

5. *Diversification of Investment Structure* TDI in Xiamen tends to concentrate in manufacturing industries, producing light industrial/consumer goods. In 1990, for example, 86 percent of Taiwan firms were engaged in manufacturing operations, making up 78 percent of total Taiwan investment amounts. Since 1991, service industries, however, particularly

[14]. R. E. Caves argues that foreign investors having a competitive edge in overseas marketing are likely to play an active role in the export marketing of their subsidiaries. See Caves (1971).

real estate, have become the new focus of TDI. At present, they account for 12 percent of all Taiwan projects and 20 percent of investment capital. Indeed, real estate has become the second largest investment sector, smaller only than the chemical industry (*BR*, Jan.27-Feb.2,92: 18). Two-thirds of property developers are known to come from Taiwan, and they, together with thousands of contracted builders, have created a booming property business in Xiamen (Xu, 1992: 121).

6. *Growing Size of Investment* Before mid-1988, Xiamen did not have a single TDI project involving more than US$10 million and average capitalization was only US$736,355 per project (Hu, 1990: 14). Most TDI projects were the same scale as local TVEs. Since the second-half of 1988, however, the situation has changed as a result of the political initiative taken by the Taiwanese authorities. More than half of Taiwan's Top 100 Companies (including the FPG) have sent delegations to Xiamen to explore the possibility of investment. As a result, a total of 11 big contracts involving US$10 million each had been signed by the end of 1990, with the largest investment worth US$200 million (*BR*, Jan.27-Feb.2,92: 17). This has increased the average capitalization to US$3.469 million per project, compared with only US$1.350 million for the non-Taiwanese FDI projects (Zhang Fenqing, 1990: 3).

Furthermore, many existing Taiwan firms have expanded their operations in Xiamen by reinvesting their profits. For instance, the Sandexing Industry Co. Ltd., set up in 1985, has expanded its production capacity 11 fold and is planning to build a new industrial park housing 16 other Taiwan firms. Also, the Xianglu Chemical Co. Ltd. has, in addition to considering the establishment of weaving projects, asked to build new plants to produce related high-pressure packaging containers (*BR*, Jan.27-Feb.2,92: 18).

Taiwan investors have shown increased willingness to extend the length of their investment term. Table 6-3.5 shows that, from July 1987 to June 1989, the shares of the firms having an investment term of over 20 years increased substantially, while those below the term dropped sharply. By

the beginning of 1992 some firms had extended their investment terms to 70 years (ibid: 17).

Table 6-3.5. Composition of Taiwan firms in Xiamen by length of investment term (July 1987 - June 1989)

	July 1987 - June 1988		July 1988 - June 1989	
Length (year)	No. of firm	%	No. of firm	%
Over 30	9	12.68	45	36.00
20 - 29	17	23.94	35	28.00
10 - 19	43	60.56	45	36.00
Below 10	2	2.82	0	0.00
Total	71	100.00	125	100.00

Source: Hu Peizhao *et al.*, (1990), p. 16.

Thus a new investment pattern has emerged: the first pattern was of single investment in manufacturing by small or medium firms; now this is gradually shifting to a pattern of joint investments (or developments) in both manufacturing and service industries by several companies, company groups or even congrulmerates. There has also been a shift from renting workshops or buildings to buying them and, more recently, to leasing or buying a piece of land to develop it into an exclusive Taiwan investment zone or industrial park.

7. *Generally Good Performances* In contrast to the rather unsatisfactory situation in all FDI projects, the financial performance of Taiwan firms appeared good. Since many Taiwan firms are small, light and self-equipped manufacturing ventures, they have flexibility to plan short gestation periods, and are normally able to sign contracts, go into operation, and get returns within a year. According to a sample survey carried out by the Chinese Academy of Social Sciences, about 95 percent of Taiwan firms in Xiamen were profitable (*JB*, 1/92: 79). This ratio is considerably higher than the 53 percent for the non-Taiwanese FDI firms. The footwear factories, for example, were reported to make 10-15

percent more profits in Xiamen than in Taiwan (Kong, 1991: 34). Because of good performance, many firms start playing an important role in their parent corporations or their fields. Cankun Electric Appliance Co. Ltd., for instance, now produces two-thirds of the total output value of its general corporation (*BR* Jan.27-Feb.2,92: 17); while the Sandexing Industry Co. Ltd. has become the world's second largest manufacturer of conductive rubber (Xu, 1992: 120) .

6-4. Major Effects of Taiwan Investment on the Xiamen Economy

Taiwan capital, as the largest source of FDI in Xiamen, has played a crucial role in its economic development in recent years. The most evident contributions made by Taiwan firms to Xiamen have been the creation of employment, increase in exports, and expansion of tourism.

1. *Reducing Importance of the State-Owned Sector* As in other parts of China, Taiwan firms in Xiamen grew much faster than local Chinese enterprises, especially SOEs. At present, there are several Taiwan firms producing more than US$30 million worth of GVIO monthly (*JJDB*, 16/3/92: 10). As a result, the share of the state-owned sector in the economy has declined steadily, while that for the private sector (including Taiwan- and other foreign-owned) has risen. By the end of 1991, for example, the GVIO and exports of some 200 Taiwan firms in Xiamen accounted for about one-fifth and 22.65 percent of the SEZ's totals respectively (*JJRB*, 8/1/92: 4; *BR*, Jan.27-Feb.2,92: 17). Together with all other FDI firms, they made up about 52 percent and 80 percent of the SEZ's total GVIO and exports respectively (*JJDB*, 1/1/92: 28).

Thus it is clear that the role played by the state-owned sector in Xiamen's economy has diminished significantly. Facing stiff competition from Taiwan and other foreign firms, some inefficient local enterprises, especially SOEs, find it hard to survive. For instance, the Xiamen Mechanical Engineering Plant, one of leading SOEs in the SEZ, was forced

to close down in 1991 (Xu, 1992: 120).

2. *Overriding the Local Industrial Development Plan* In the book, *Xiamen Socio-Economic Development Strategies for 1985-2000*, the Xiamen authorities (like their counterparts in other SEZs) decided to put the development of *electronics* as their top priority in the hope that it would, through FDI, become the leading industry by 1995. This decision was made on the grounds that "electronics will pioneer Xiamen's industrial transformation through its extensive linkage effects" (Research Office, 1989: 139). However, the growing influx of TDI since 1988 has swept the plan aside. As shown in Table 6-3.3, TDI in Xiamen was dominated largely by chemical industry (48.76% of total investment), and the share of the electronics industry was almost negligible (1.87%).

Thus the sectoral structure of TDI did not coincide with the Xiamen's own industrial transformation plan. Faced with this divergence, the Xiamen authorities abandoned their original goal and declared petrochemicals be their new "investment emphasis" (*BR*, Jan.27-Feb.2,92: 19). Indeed, a great deal of work has been done to accommodate more and bigger petrochemical projects from Taiwan.

3. *Lack of Linkage Effects* Most of the Taiwan firms in Xiamen are characterized by what local people call as "five self-responsible's" (*Wuge Ziwofuze*), i.e. they are responsible for their own capital, technology, raw materials, management and export markets. This means that, apart from making use of local cheap labour and land, all other inputs are brought from Taiwan. For example, more than three-quarters of all raw materials, components and parts needed by Taiwan firms in Xiamen were imported from Taiwan and about 85 percent of their finished products exported to existing overseas markets in 1990. Some midstream factories even invested with upstream or/and downstream factories, and formed a self-sufficient, self-sustained operational system, almost wholly independent of the local economy (*XMTQYJ*, 3/91: 17-18; Kong, 1991: 34).

Moreover, as most of the Taiwan firms were wholly owned (77.52%, see Table 6-3.2), top- and middle-level managerial

personnel were normally sent from their parent corporations in Taiwan and controlled all aspects and stages of their operations in Xiamen. Xiamen employees with low-level management responsibilities accounted for less than 30 percent of the total number of managerial staff and played only a minor role in the decision-making process (*XMTQYJ*, 3/91: 17-18).

Clearly, these enclave operations have little linkage (forward or backward) and demonstration effect on the local economy. As a result, the plan to make use of TDI to transform local industrial enterprises and to stimulate the development of other related industries is still far from being reality.

4. *Limited Technology Transfer* According to another sample survey, about 65 percent of technologies imported by the Taiwanese are judged as *appropriate* to Xiamen's conditions. The Taiwan shoe-manufacturing technology, for example, has been carefully studied and then modified by the Fujian Mechanical Engineering Bureau, with a view to equipping all mainland's shoe-making factories with the same technology. Also, several Taiwan firms have brought in some practical technical know-hows and/or the Western manufacturing standards, e.g. "UL" of the U.S.A., "CSA" of Canada, "JIS" of Japan, and "RDEF-TUV" of Germany, to manufacture some products with well-known brands, such as "Philips" and "Esars" (Yan, 1990: 34).

On the other hand, as we have seen, many Taiwan firms are small-scale and labour-intensive enterprises, producing light industrial/consumer goods. Thus in most cases the technologies employed are simple, mature, and standardised. A considerable amount of their capital equipment are second-handed directed shipped from factories in Taiwan. Of the 200 identified technologies introduced so far, "very few" could really be regarded as sophisticated (*CBTR*, 1/92: 14; Yan, 1990: 28).

5. *Increasing Employment Opportunity* The total number of people working in Taiwan firms is now around 45,000. More profoundly, in 1990 the number of people engaged in self-employed businesses, which flourished due largely to the

influx of TDI, increased by 92 percent, the highest growth in the country (Xu, 1992: 121). The Xiamen authorities spent only ¥140 million on facilitating these employment opportunities. It was estimated that if the jobs had been created solely by the authorities it would cost them at least ¥700 million (Kong, 1991: 34).

6. *Mixed External Effects* Apart from taxes, rents and charges paid to the local authorities, TDI has created several other positive external effects. First, it has stimulated real estate business and substantially improved the efficiency of infrastructure construction. Before 1988 only about 50 percent of a large number of standard factory buildings, which costed the authorities ¥420 million to build, had been leased out. Since 1988, however, all the empty buildings have been rented to or bought by the Taiwanese. Many late arrivals had to settle in makeshift buildings or rent empty space in local factories. As a result, the authorities claimed that they had recovered all constructing costs of those buildings by 1989, with a rate of returns of 162 percent (Hu, 1990: 17).

Second, TDI has created a desirable social effect on Xiamen and the neighbouring areas by generating employment. The average annual salary for a worker in a Taiwan firm is about ¥5,000, which is 4 times higher than the local annual living costs (¥1,250). Thus a worker employed in a Taiwan firm can support other 3 people in his or her family, compared with only 0.87 people in the case of a worker employed by a local Chinese factory. As 80 percent of the 45,000 employees came from poorer rural regions around Xiamen, the beneficial effects created by Taiwan firms is indeed immense (Kong, 1991: 34).

Third, it has promoted the development of tourism in Xiamen. During the period of 1989-90, the number of foreign tourists visiting the PRC dropped sharply because of the Tiananmen Square Incident. In Xiamen, however, the number of Taiwan "tourists," many actually looking for business opportunity, reached record highs of 73,000 in 1989 and of 136,000 in 1990 (AXSEZ Editorial Board, 1990: 333). Indeed,

Xiamen hotels had unusually high occupancy rates at that time. Tourist number continued to grow in 1991 when taxes paid by the tourist industry to the SEZ authorities were reported to "increase substantially" over the previous year (Xu, 1992: 121).

fourth, it has induced investment from more than 30 Japanese firms, which are business partners of Taiwan firms currently operating in Xiamen (Xu, 1992: 120).

However, the massive influx of Taiwan capital and personnel has also brought some unwelcome changes to the local population and economy. First, it has contributed to push up inflation. In 1988 and 1989, the price index of living costs for local people rose by 28.9 percent and 24.0 percent respectively, leading to the deterioration of living standard for 17 percent of families in Xiamen (XSB, 1989: 352; AXSEZ Editorial Board, 1990: 305).

Second, the growing number of immigrants working in Taiwan firms has exerted a great pressure on housing, city-wide transport, schooling and entertainment facilities. It has led to an increase in crimes and other illegal activities in Xiamen. This problem has been aggravated by the fact that many Taiwan investors bypassed the local Labour Management Bureau to employ even cheaper labour from the rural areas around Xiamen. The real estate speculation, instigated mostly by the Taiwanese, has also pushed up property prices to an unduly high level.

And finally, the perceived superiority of employment in Taiwan firms has seriously affected the morale of employees in local Chinese enterprises, particularly SOEs. The wages and salaries of the former are about 2.14 times higher than those of the latter. As a result, many talented professionals and skilled workers have left their Chinese units for Taiwan firms, leaving the Chinese ones further declining (Kong, 1991: 35).

In short, the effects of TDI on the Xiamen economy have been profound, but they are by no means as influential and

indeed crucial as those of Hong Kong investment on the Shenzhen SEZ, where a close economic integration between the two economies is taking place. Despite the achievement of attracting a greater inflow of Taiwan capital, Xiamen has failed to integrate TDI into its economy, in particular to make use of TDI in transforming its outmoded industry, through establishing extensive economic and technological linkages between the local and Taiwan firms.

6-5. Conclusions

The most evident result of the industrial transformation in Xiamen, as often proudly claimed by the authorities, has been the rapid expansion of industrial output and exports during the period of 1981-89, with 23.66 percent and 22.08 percent of the average annual growth rate, respectively (see Table 6-1.3). As a result, the share of GVIO and exports in the SEZ's total GDP went up from 67.02 percent and 30.97 percent in 1985 to 83.41 percent and 60.73 percent in 1989, respectively (AXSEZ Editorial Board, 1986: 70; 1990: 154; XSB, 1986: 397). Such big increase in the two shares does represent a marked advance towards Xiamen's goal --- an export-led industrialization.[15] However, this does not mean that Xiamen's old and inefficient industry has been transformed because nearly 49 percent of output and over 28 percent of exports in 1989 were contributed by newly operated FIEs in the SEZ (see Table 6-1.3).

Several important issues, emerging from the discussions in this chapter, can be further elaborated as follows:

First, Xiamen's present industrial transformation has been plagued by the profound lack of interdependence and linkage effects among various industrial sectors --- a legacy of the former fragmented and autarky economy --- and between

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[15]. Experience in many developing countries shows that a rapid rise in industrial output and decline in agricultural output is a typical feature of industrialization. For details, see Meier (1989), pp. 288-93; James, *et al.* (1987), pp. 33-4; and Chenery, *et al.* (1986), p. ix.

the foreign-involved and local sectors --- a result of the enclave-type development of FDI.

Admittedly, lack of interdependence and linkages is the most typical characteristic of underdeveloped economies. In view of the situation of utilising FDI in China, a senior World Bank officer urges the Chinese government to pay adequate attention on the development of backward and forward linkages and indeed "make them an integral part of its policy and strategy for FDI." "Such linkages," he argues, "would not only promote development of feeder and downstream industries, but would also help to improve the cost efficiency and quality of products of industries and, thus, promote their exports" (Khan, 1991: xiii).

However, the problem faced by Xiamen is somewhat special, in the sense that it has been compounded by the ill choice of the leading industrial sector and the accelerated proliferation of TDI. Most of the TDI projects in Xiamen were engaged in what Hirschman termed as the "antiseptically linkage-free" activities. The so-called electronics industry in Xiamen has little linkage effect on other sectors and cannot catalyze the industrial transformation. Without doubt, if the authorities had chosen the longer- and better-established machinery sector as the leading industry the result would have been quite different.

Second, the Xiamen authorities' policy toward TDI has also been responsible for the relatively poor quality of TDI projects in Xiamen. They offered more financial incentives to Taiwan investors than to non-Taiwanese foreign investors. What is more, the local enterprises competed fiercely with each other in offering even more concessions to the Taiwanese. That is why so many low-level or "sunset" projects have been attracted into the SEZ. More importantly, the double standards have not only created confusions in the incentive policy but also seriously damaged the prospect for non-Taiwanese foreign investors, particularly those from the industrialized West or with advanced technology, to come to Xiamen.

In fact, it is not necessary to offer extra financial

concessions to Taiwan investors. Many of them would rather to see an increase in the ratio of local sales, relaxation of credit controls, and opening more sectors and markets to them (*JJDB*, 25/5/92: 22).

Third, the enclave-type development of FDI has created another serious problem in Xiamen --- a dual economy, with the fast growing, modern, foreign-transplanted, capitalist sector coexisting with the stagnant, backward, indigenous, socialist sector. The results of this increasing divergence is that more and more scarce resources, especially professional people, are drawn into the former sector form the latter one. Clearly, if the Xiamen authorities do not take immediate actions to narrow the disparity, they will soon face serious economic, technological, social, cultural and, eventually, political consequences.

And finally, the increasing presence of TDI has not only exacerbated the enclave-type development of FDI in Xiamen but also created a potential conflict with Xiamen's long-term development goal. Clearly, Xiamen is more suitable for developing an EPZ-type zone since it has got a considerable manufacturing capacity, improving sea and air transport links, and abundant labour resources. However, since the economic contacts with Taiwan resumed and expanded, the Xiamen authorities have apparently become more enthusiastic about the goal of building a Free-Trade-Port, rather than "an industry-oriented comprehensive SEZ," on the grounds that Xiamen could benefit from the entrepôt trade between Taiwan and mainland China (Zou, 1988; Wu Yongchun, 1991). Given the fact that there is virtually no prospect of direct trading between the two sides in the foreseeable future, it is therefore not clear that in making a further change towards the establishment of a Free-Trade-Port the benefits would exceed the costs.

Also, as we have seen, when facing the conflict between the main interest of TDI (petrochemicals) and the priority of the local industrial development (electronics), the authorities abandoned the original development priority and became in favour of the petrochemical industry. That is to

say, Xiamen's original industrial development plan has, to a large extent, been hijacked by the mighty Taiwan capital. Indeed, if Taiwan's petrochemical projects continue to be allowed to flood into Xiamen without being subject to a stringent scrutiny, the authorities will soon find that Xiamen is becoming Taiwan's another petrochemical city, with all its unique tourist resources being destroyed by pollution.

Thus, as far as the relationship between the local economy and FDI is concerned, it is the increasing domination of Taiwan capital in the local economy which has led to the Xiamen authorities readjusting their industrial development policy and hence contributed to the inconsistency, ambiguity and unpredictability in the zone policy.

To sum up, despite the achievement of attracting a greater inflow of foreign capital, the Xiamen authorities have failed to design a policy framework which would facilitate the integration of FDI into the local industry by establishing extensive linkages between the foreign-involved and local sectors. The integration is vital for Xiamen because it is the best way to transfer and diffuse advanced foreign technology into the local economy, to safeguard against enclave-type development of FDI, and, above all, to stimulate the domestic industrial transformation. Clearly, due to the small size and high labour-intensity of most of the FDI, especially TDI, projects in Xiamen, the transferability of its experience in utilizing FDI to transform the local industry for the country's industrialization programmes appears to be very limited.

Chapter 7

THE FOREIGN TRADE LIBERALIZATION AND PRICE REFORM IN XIAMEN

Since it was designated as a SEZ, Xiamen has always put the reform of its foreign trade system high on its economic development agenda. With the increasing expansion of the economic contacts with Taiwan in recent years, it has set itself the ambitious task of becoming a Free-Trade-Port (FTP) by the year 2000 (Research Office, 1989: 4).

In pursuing this task, Xiamen has to deal with problems not only resulted from the conflict between the old, centrally planned and the new, market-oriented systems, as observed in Chapter 5 and 6, but also those caused by the conflict between the rigid, largely inward-looking trade regime still implemented in interior China and the more flexible, outward-looking trade policy conducted in the SEZ. These problems include: 1) those typical of China's trade decentralization, such as chaos and severe internal price competitions due to the interest conflicts between the central ministry and the locality, between the state and the trading company, and among companies themselves; and 2) those commonly observed in the developing countries reforming their trade policy, such as large government deficits, chronic shortage of foreign exchange, and high inflation.

Thus, Xiamen faces another unprecedented challenge, apart from the two discussed in the previous two chapters, of transforming the old, import-substitute inward-looking trade regime into a new, export-oriented outward-looking system. During this process, Xiamen has to deal with an important relationship: the one between the domestic economic reform and the foreign trade liberalization. Among various domestic

reforms, price reform is the most important one because it has crucial effects not only on industrial reform but also on trade reform as well.

In fact, foreign trade reform and price reform are closely linked to each other because of their complementary effects. The best way to remove price distortions for a command economy seems to be to open its economy to the international trade and competitions, thus bringing domestic prices closer to world prices. On the other hand, the benefits of trade reform could be greater when accompanied by a fundamental price reform. In other words, decentralized trade can facilitate the formation of an appropriate price system and vice versa.

The purpose of this chapter is, therefore, to examine the relationship between the foreign trade reform and the price reform in Xiamen. After identifying the problems emerging from the trade reform in Section 7-1, this chapter starts examining the interaction between the price reform policy and the Special Policy in Section 7-2. Section 7-3 goes on analysing the relationship between price distortions and the trade problems; Section 7-4 explores the relationship between trade expansion and inflation; and finally Section 7-5 concludes this chapter with important findings.

7-1. Problems in the Foreign Trade Reform

As a historic trading port, Xiamen has long had an ambition to restore and expand its traditional trade links with the outside world. It is therefore quite natural for the Xiamen authorities to have made greater efforts to reform the foreign trade system. The result of the efforts has been that 242 new trading entities had been created by the end of 1989, compared to only 8 in 1980. As shown in Table 4-3.9, export volume grew rapidly, with an average annual growth rate of 21.94 percent for the period of 1981-90, compared to only 16.88 percent for the prereform period of 1950-80.

However, a series of problems have arisen in the trade

reform. Some of them are similar to those commonly observed in developing countries experiencing the transition from import-substitution to export-led industrialization, while others are unique to the Chinese SEZs caused largely by the conflict between the new, more flexible trade policy and the old, rigid approach. The most serious problems appeared to be: 1) the sharp increases in export costs; 2) the severe shortage of export supplies; 3) lack of domestic capital supplemental to export production; and 4) rise of trade-induced inflation (AXSEZ Editorial Board, 1990: 107; Lin Jianhan, 1990).

1. The increases in export costs have led to heavy losses for a large number of exporting firms. This was due largely to the rampant inflation in the mid-1980s, which sharply pushed up the domestic procurement prices of many raw materials and export inputs. To illustrate, the prices of cashmere, goatskin and the bark of eucommia (a popular traditional Chinese medicine) went up from ¥18,500 per ton, ¥4.8 per piece and ¥2,667 per ton in 1984 to ¥65,700 per ton, ¥21.1 per piece and ¥16,308 per ton in 1986, increasing by 255.14 percent, 339.58 percent and 511.47 percent, respectively (Zhao Tiecheng, 1989). Undoubtedly, this wild increase in the domestic procurement prices of export supplies, especially agricultural, animal and native products which constituted the bulk of Xiamen's export sources, produced a devastating effect on local trading companies. Many previously profitable commodities have become unprofitable to export within a short time (Zhang Xie and Liu Xinhua, 1986: 35).

This problem was aggravated by the overvalued exchange rate, which led to a further loss on the part of exporters when they handed over a part of foreign exchange they had earned to the Bank of China. Despite a series of depreciations of the Renminbi nationwide since the late 1970's, runaway inflation has far outstripped the depreciations, rendering the country's real effective exchange rate declining.[1] As a

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[1]. For more discussions of the patterns, causes and cures of China's inflation in recent years, see Naughton (1992).

For changes in China's exchange rate (against US$) since

result, "more exports," to quote a local official, "often means more losses for trading companies and hence bigger subsidies from the state" (Chen Guangchong, 1988: 38).

2. The deterioration of the real effective exchange rate, combined with the existence of a protected domestic market, has made it less profitable for Xiamen to export than to sell domestically. In particular, the ever increasing demands in the domestic market for consumer goods, which made up the majority of Xiamen's exports, have made domestic sales even more attractive. As a result, the bulk of the outputs produced by the local SOEs was still domestic-market-oriented in the almost entire period of 1980s. In 1988, for example, the ratio of local sales, interior sales and exports was 30:60:10 (Du Qiang, 1988: 58).

3. Fierce competitions between Xiamen and interior regions to get limited export supplies has further pushed up domestic procurement prices of export supplies in the SEZ. The problem is particularly acute for Xiamen since nearly 80 percent of its export supplies came directly from interior regions (Meng Zen, 1989: 52). In order to fulfil their own export quotas and hence gain foreign exchange retention, many interior regions were reluctant to sell their products to the SEZ, which consequently had to offer either extraordinarily high purchase prices, or other economic incentives, such as forming economic associations whereby the interior partner would be entitled to certain tax and foreign exchange concessions, to get export supplies. Obviously, this has not only increased the costs of export significantly for Xiamen but also seriously distorted prices in the domestic market, creating a direct conflict of economic interest between the SEZ and various interior regions.

4. The "price wars" have pushed up not only the procurement prices of exportable goods but also the retail prices of almost all consumer goods in the domestic market. In 1986, for example, Shaanxi Trading Corporation of Native and

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1980, see Table 3-2.1.

Animal Products signed purchase contracts with various localities in the province and set the procurement price for walnuts at ¥6,100 per ton; but the companies from Xiamen offered higher prices and hence attracted more goods. This forced the Shaanxi Corporation to raise its price to ¥6,800 - 7,100 in November of the year, however, the SEZ companies went further --- increasing the price to ¥8,000 --- leaving the local Corporation only able to complete 56.52 percent of its procurement plan for the year. In 1987, the Shaanxi Corporation determined to keep its own export product at all costs by increasing the price to ¥7,400 Yuan, and yet it only managed to get 17.39 percent of the supply because the SEZ companies offered an even higher price (¥10,000) to local sellers. An immediate result of this price war was that the retail price of walnuts in Shaanxi went up by nearly 250 percent during the two years, which was of course a contributing factor for the 30.17 percent of inflation rate for the province in the same period (*TGXX*, 3/89: 45). Thus it is not surprising that the Xiamen SEZ (indeed all SEZs) has been accused of "causing trade-induced inflationary spiral in the interior" (Meng Zen, 1989: 53).

5. The tight monetary policy, imposed nationwide by the central government since 1988 in order to cool off the overheated economy, has made many trading companies in Xiamen run into a cash crisis, interrupting their normal trading businesses. In 1989, the number of companies failing to fulfil their export contracts increased and, compared to 1988, the export volume of the specialized trading companies and the local companies fell by 10.9 percent and 11.2 percent, respectively (AXSEZ Editorial Board, 1990: 45).

6. Despite the steady increase in the share of labour-intensive light industrial products, nearly half of exports in 1989 were still primary products, including agricultural, native and sideline products, and minerals (see Table 7-1.1). Most imports, on the other hand, are manufacturing/processing/assembling components and parts mostly bound for FIEs (see Table 7-1.2). This indicates that Xiamen faced the structural

Table 7-1.1 Commodity composition of Xiamen's exports (1985 - 1989) (%)

Year	1985	1986	1987	1988	1989
Foodstuffs & agricul. goods	36.34	38.99	35.66	39.66	30.04
Native & sideline products	32.69	23.04	17.60	14.26	9.27
Light industrial products	4.39	13.33	22.07	18.97	28.55
Metals & minerals	4.58	3.81	7.07	12.33	8.71
Textile	0.47	3.09	3.87	4.06	10.52
Machinery & equipment	5.35	5.88	6.55	4.84	4.55
Chemical & medicinal goods	0.25	10.32	5.69	5.12	6.91
Others	15.93	1.52	1.54	0.75	1.52
Total	100.00	100.00	100.00	100.00	100.00

Sources: 1). 1985: XSB (1986), p. 397;
2). 1986: XSB (1987), p. 351;
3). 1987: XSB (1988), p. 329;
4). 1988: XSB (1989), p. 371;
5). 1989: the AXSEZ Editorial Board (1990), pp. 6 & 325.

Table 7-1.2 Commodity composition of Xiamen's imports (1985 - 1989) (%)

Year	1985	1986	1987	1988	1989
Foodstuffs & agricul. goods	5.96	6.63	5.69	16.16	17.97
Light industrial products	8.71	9.80	3.55	14.65	21.01
Textile	8.55	0.31	0.02	0.70	1.55
Medical & chemical goods	1.56	5.68	19.52	27.33	25.98
Metals & minerals	4.50	3.69	3.02	2.32	9.12
Machinery & equipment	47.99	63.39	33.30	24.13	11.15
Precision instruments	0.12	10.49	14.75	7.96	10.66
Others	22.60	-----	3.45	6.75	2.57
Total	100.00	100.00	100.00	100.00	100.00

Sources: 1). 1985: XSB (1986), p. 398;
2). 1986: XSB (1987), p. 352;
3). 1987: XSB (1988), p. 330;
4). 1988: XSB (1989), p. 372;
5). 1989: the AXSEZ Editorial Board (1990), p. 326.

problem that the foreign exchange needed by rapidly expanding manufacturing sectors was largely generated by slowly growing exports of primary products and labour-intensive light

industrial products, which generally face stagnant or even declining demand in the world market.

7. As shown in Table 4-3.9, despite the rapid growth of exports over the period 1981-90, the average annual growth rate (21.94%) is still lower than that of industrial development (GVIO) for the same period (23.24%), in contrast to the pattern often observed in successful EPZs, where the former figure is generally higher than the latter one. Furthermore, the growth of exports has not been as consistent and steady as that of industry and indeed even showed a steady decline in the first three years of the period. As a result, as shown in Table 7-1.3, the first five years of the SEZ (1980-84) witness only 5.96 percent growth of exports per year --- a speed which is even much slower than several previous FYP periods, despite a sharp increase at the second stage (1985-89).

Table 7-1.3 Average annual growth rates of exports in Xiamen in eight different periods (%)

	Rehabilitation 1950-52	1st-FYP 1953-57	2nd-FYP 1958-62	3rd-FYP 1966-70	4th-FYP 1971-75	5th-FYP 1976-80	SEZ Period 1980-84	1985-89
Exports	15.00	26.86	-2.10	2.13	27.68	23.33	5.96	47.81

Sources: 1). 1950-80: the AXSEZ Editorial Board (1986), pp. 122-3;
2). Table 4-3.9.

8. The Xiamen SEZ, like other Chinese SEZs, has also actively engaged in "parallel trade." For example, in 1985 due to the severe internal price competition, Xiamen overstocked more than 700 tons of tinned mushroom, exported 30 percent more, and thus caused 25 percent fall in exporting prices, leading to a loss of over one million U.S. dollars (Zhou Yunyuan, 1987: 59). Also, about 70 percent of manufactured imports sold by Xiamen to domestic users in 1985 were priced at approximately 50-100 percent higher than the original import prices (Chen Guangchong, 1988: 38).

One must, therefore, ask why, after ten years of reform and development as a SEZ, the above trade problems have not

been removed or mitigated? in other words, what role have the economic reform, especially the price reform, and the Special Policy played in the reform and development of Xiamen's foreign trade?

7-2. The Price Reform Policy and the Special Policy

Local economists have persistently emphasized the importance of a price reform in Xiamen (e.g. Fang Xiaoqiu, 1984; He Lifeng *et al.*, 1986; Su Yanhan, 1989). The Xiamen authorities also called for a deepening of price reform in order to "promote the readjustment of industrial structure and the efficient allocation of resources" (Research Office, 1989: 129). In particular, they argued that the need for a swift and effective price reform was more acute in the zone because of the increasing role played by FDI in the zone economy, and of the rapid development of economic associations between the SEZ and interior regions (Ni Shidao and Wang Yang, 1989: 16-7).

At the same time, some Chinese economists have contended that the SEZs are generally more capable of withstanding the pressures of inflation brought about by the price reform, on the grounds that they have established a preliminary link between wage increase and price growth. Therefore, the SEZs are, they conclude, the ideal places in China for carrying out a radical price reform (Zhu Tiezhen and Zhou Tianyuan, 1989).

The Price Reform Policy

Unlike the Shenzhen SEZ, where the price reform has been independent of the domestic economic reform, Xiamen has basically followed the policy of the domestic price reform, except that a wider floating range is allowed in the prices of few commodities (Ni and Wang, 1989: 31). This was based on the consideration that the old, central-planning economic system and elements were more deep-rooted in Xiamen than in other SEZs. Of course, the failure to build a "second board" to isolate the zone from the rest of the country was also a

reason.

Thus, the price reform policy has been very similar to that of Fujian province[2]. The chief objective of the reform was to "realize the adjustment of industrial and product structures through adjusting irrational prices on the one hand and decentralizing the price management system on the other." Based on the principle that "enterprises should have full autonomy to decide the price of their products," the new price system would be "dominated by the free price and supplemented by the planning price" (ibid: 18 & 41).

The price reform in Xiamen can be divided into three distinct stages. The first, from 1978 to 1984, concentrated on the restructuring of the prices of agricultural products, mainly in rural areas. The second, from 1984 to 1986, coinciding with the expansion of the Xiamen SEZ into the whole Xiamen Island, focused on the reform of the prices and price management system of industrial products, primarily in urban areas. The third, from 1987 to 1990, was, after suffering a setback, at a low ebb.

However, Xiamen did enjoy some bigger autonomy in terms of price management. This includes: 1) full autonomy to decide the aggregate level of social retail prices; 2) autonomy to set prices for goods and services, except for those items controlled by the state; and 3) freedom to adjust the prices of those items controlled by the state if approved by the state (ibid: 18-9).

Perhaps the most significant change brought about by the price reform has been the introduction of the so-called "dual-track system" (*Shuanggui Zhi*) in the management of the prices of producer goods and the establishment of some factor

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[2]. This can also be identified in a series of documents issued by the Xiamen authorities or speeches made by their leaders. For example, Mr. Wang Jingshui, one of deputy mayors, stated in 1986 that "the price management should emphasize on controlling the price level and ensuring it relatively stable" (AXSEZ Editorial Board 1986: 13). In 1988, Mr. Zou Erjun, the mayor, also called for "consolidating and further digesting those reform measures already taken in the national price reform" (Zou Erjun, 1988).

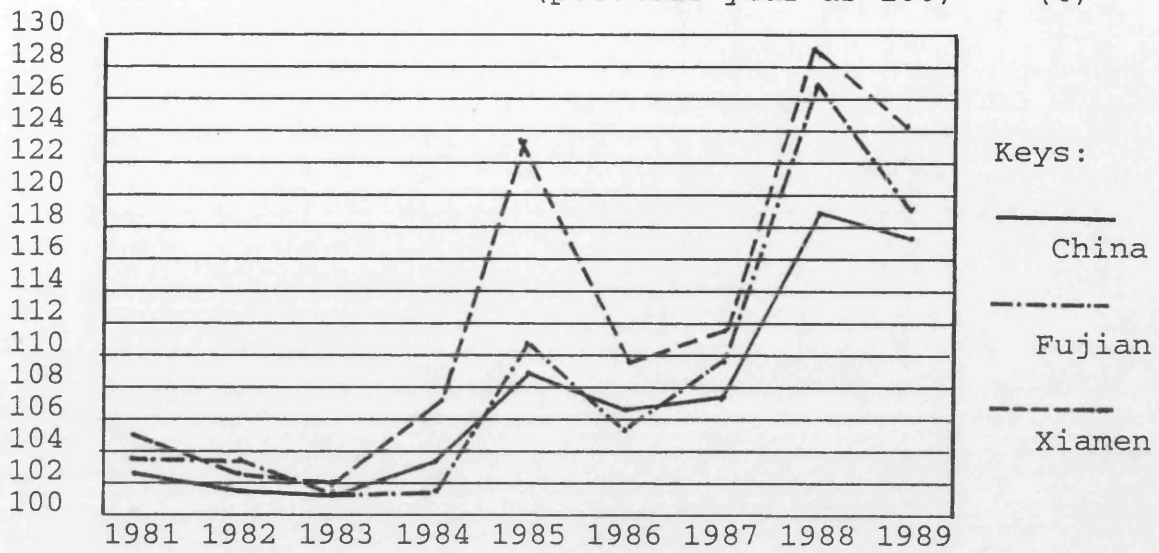
markets. Under this new system, all producer goods were divided into two portions: the planned (*Jihua Nei*) and the unplanned (*Jihua Wai*). The first group of goods continued to be distributed by the state-controlled material-supply channels and their prices set by the state, while the second group would normally be distributed through the newly established factor markets and their prices set by distributors themselves on the basis of market forces.

As a result, factor markets, such as the exchange centres for steels, chemicals, vehicles, building materials, and waste materials, have been set up. Producers or dealers were encouraged to sell their overproduced or overstocked goods in these markets. Consequently, the shares of the unplanned portion for most physical inputs of production have surpassed 50 percent, well above the national average levels. For example, in 1987 the "unplanned" supply of cement made up 87 percent of the total supply, steels 80 percent, soda ashes 60 percent, rubber 69 percent, petrol 65 percent, diesel oil 74 percent and timber 100 percent (ibid: 69-70).

Important Features With various reform policies and many types of prices simultaneously operated in Xiamen, several important features have arisen:

1. As can be seen from Figure 7-2.1, while the general trends and fluctuations are very similar, the price level in Xiamen is generally higher than those of Fujian province and the nation as a whole. This indicates that the price reform in Xiamen has been conducted largely in parallel to the domestic reform.

Figure 7-2.1 The retail price indexes in China, Fujian province and the Xiamen SEZ (1981 - 1989)
(previous year as 100) (%)



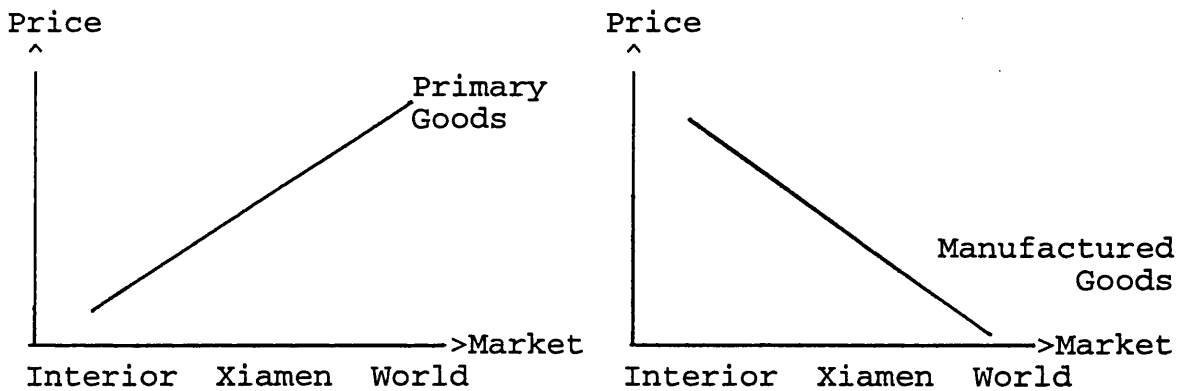
Sources: 1). 1981-87: Ni and Wang (1989), p.47;
2). 1988-89: China: *RMRBh*, 14/3/91, p. 3; Fujian: FSB (1990), p. 267; Xiamen: XSB (1989), p. 352 and the AXSEZ Editorial Board (1990), p. 305.

2. The "Two-Ladder-Price" pattern (*Liangge Jiage Jieti*) has emerged, linking the interior, Xiamen and world markets together. That is to say, after several years of the price reform, the prices for most primary goods in the SEZ have become *higher* than those in interior China though still *lower* than those in the world market (see Figure 7-2.2a). On the other hand, the prices for most manufactured goods in the zone have become *lower* than those in interior China though still *higher* than those in the world market (see Figure 7-2.2b). For example, in 1988 the world prices and the zone prices for grain were 20.8 percent and 6.7 percent, respectively, higher than the Chinese domestic prices, whereas for chemical products the domestic prices and the zone prices were 5.6 percent and 3.7 percent, respectively, higher than the world prices (ibid: 122; *XMTQYJ*, 3/89: 23)[3]. This shows the tendency of zone price moving away from domestic prices and toward

[3]. The comparison between the world prices and the Chinese domestic prices is based on the exchange rate of US$ 1 to ¥5.7, which is the regulated market rate introduced since June 1988 (Ni and Wang, 1989: 122).

world prices --- a situation the reform is expected to bring about.

Figure 7-2.2 The pattern of "Two-Ladder-Price" among the interior, Xiamen and world markets



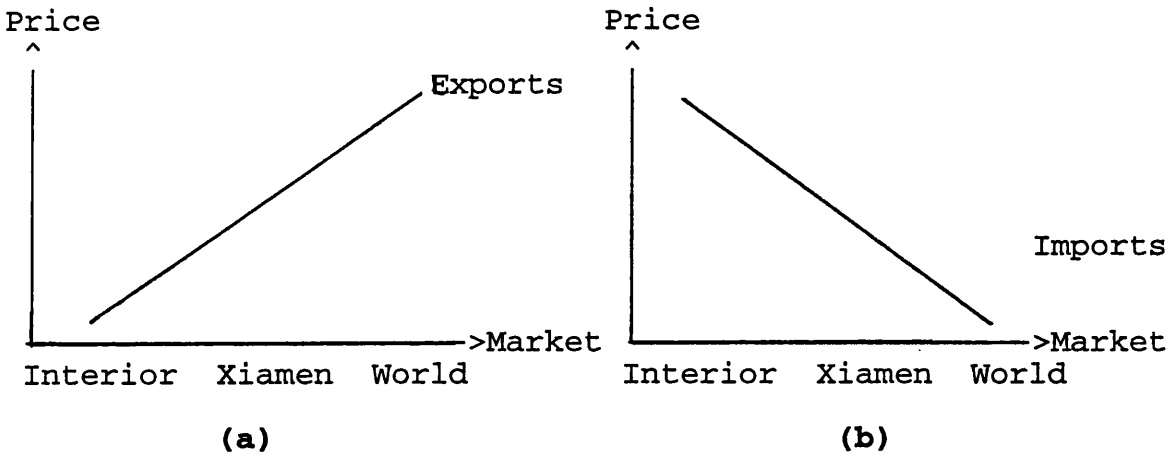
Source: Ni and Wang (1989), p. 46.

3. The "Two-Way-Slope" (*Shuangxiang Qingxie*) pricing policy has been set for exports and imports. The policy requires that all exports, such as raw materials, agricultural products and light industrial products, be priced higher than the domestic prices but lower than the world prices, i.e. forming a "outward-looking slope" for exports (see Figure 7-2.3a); while all imports, such as machinery, equipment, manufactured components and parts, and electrical appliances, be priced higher than the world prices but lower than the domestic prices, i.e. forming a "inward-looking slope" for imports (see Figure 7-2.3b).

The Chinese defended this artificial differential pricing policy by claiming that it would not only stimulate the development of exports and imports in Xiamen, but also encourage both domestic and foreign investors to invest in the SEZ. They believed that, by moving prices in the zone closer to world prices, this would force enterprises in the zone to greatly improve their efficiency and hence be able to participate in international competition. This pricing policy would also, they hoped, cushion the impact of the changes or fluctuations in world prices on the SEZ and domestic economies

(Ni and Wang, 1989: 21-3 & 86-7).

Figure 7-2.3 The "Two-Way-Slope" pricing policy for exports and imports in Xiamen



Source: Ni and Wang, (1989), p. 87.

4. Free and floating prices have played an increasing role in regulating the economy, while the role of the state price was diminishing. This happened not only in the distribution of producer goods but also in the sales of consumer goods. From 1978 to 1987, for example, the share of goods sold at the state price in the total social retail sales dropped from 98.3 percent to 37.8 percent, whereas the proportions of those sold at the floating price and the free price rose from 0.3 percent and 1.4 percent to 15.1 percent and 47.1 percent, respectively (ibid: 34).

5. Different price levels are applied on different currencies. At the moment, there are generally three kinds of currency circulating in Xiamen: RMB, the Foreign Exchange Certificate (FEC) and foreign currency [mainly Hong Kong Dollar (HK$), New Taiwan Dollar (NT$) and U.S. Dollar (US$)]. Many commodities and services in the SEZ are priced in all three currencies, with the RMB being most expensive, the FEC moderate and foreign currency the cheapest. Without doubt, such discrimination against the RMB can only exert more inflationary pressures on it, and therefore push local retail prices further up.

6. The price movement in Xiamen is very vulnerable to the

change of domestic economic climate. As can be observed from Figure 7-2.1, the overheated domestic economy in the mid- and late 1980s, caused mainly by the overexpansion of capital construction and the sharp increases in consumer funds, led to a steeper rise in the price level in the SEZ. On the other hand, the austerity economic policy, imposed by the central authorities nationwide to cool down the overheated economy, immediately brought down the price level both in the domestic economy and the SEZ. This means that Xiamen has not yet established a firm and independent economic base and was still closely linked with the domestic economy.

7. The price movement in Xiamen has gradually become sensitive to the changes in the international market and the foreign exchange rate. As basic consumer goods in the SEZ are much cheaper than those in the overseas market (see Figure 7-2.2a), the massive inflow of foreign purchasing power, brought in by foreign investors and tourists, has significantly pushed up the prices of those goods, especially foods. At the same time, with the constant devaluation of the RMB and continuous appreciation of Japanese Yen, the prices of imported manufactured goods, such as electrical appliances which constitute a considerable part of the SEZ's imports, have become higher and higher (Wang Peiyuan, 1988). All these have certainly exacerbated the inflation in the SEZ.

The Special Policy

In order to attract more foreign capital and encourage local enterprises to export more products, a variety of Special Policy or preferential treatments have been formulated by both the central and the SEZ authorities[4]. They include:

1. In terms of foreign exchange management, all

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[4]. The following information are based on the AXSEZ Editorial Board (1986), pp. 1-2; 238-9 & 302-3; *The Xiamen SEZ (Supplement to China's Foreign Trade 1989), An Investment Guide for the Xiamen SEZ (1989)*, and Zhao Tiechen (1989).

For details of the Special Policy encouraging foreign investment, see Appendix E.

exporters, be they local, domestic-associated or foreign-involved, are entitled to retain *all* foreign exchange they have earned from their exports.[5] The foreign exchange retained by zone enterprises can either be used for business and/or production purposes, or, in case of surplus, sold to other firms through the newly established the Foreign Exchange Swapping Centre at the so-called adjusted price (*Tiaoji Jiage*), which normally is 20-25 percent higher than the official exchange rate. This means that the zone enterprises can not only get more foreign exchange through the retention scheme but also more RMB by selling their unused foreign exchange than their interior counterparts.

2. All exports, be they finished or semi-finished products, from Xiamen are exempt from the export tax and consolidated (sale) tax. As to those export goods which have been subject to various indirect taxes during production and distribution, the producers and/or exporters will get full tax rebate. Enterprises with a big share of exports in their total output can link up the total wage bill with the amount of foreign exchange they earned. They are also allowed to use a part of retained foreign exchange as bonus to reward their workers and staff. In addition, trading companies in the SEZ may act as export agents for any interior producer and exporter and thereby charge 3-5 percent commission fees. Obviously, the zone enterprises generally have strong motivations to export more products and to earn more foreign exchange.

3. The zone enterprises are generally encouraged to form economic associations with interior partners to jointly design and produce new export products or upgrade existing ones (see Appendix D). They can either set up a base in an interior raw-material-producing place and organise production locally, or bring raw materials, semi-finished products or even finished

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[5]. Their inland counterparts are only allowed to keep 25 percent.

products to the SEZ for further fine processing or packing[6]. This means that the zone enterprises have been granted almost unlimited access to the interior market in securing their continual and competitive export supplies.

4. Xiamen has been granted the authority to engage in entrepôt trade and, in particular, deal directly with Taiwan. Also, Xiamen firms can deal in any export product except a dozen of goods directly controlled by the MOFERT, despite the fact that the SEZ itself only produces a small number of exports. Furthermore, they have the privilege of getting more export licences and quotas for exports to Hong Kong, Macau, Taiwan, and other Southeast Asian countries due to Xiamen's proximity to these markets, although the SEZ only has a comparatively small target of foreign exchange earnings to fulfil every year. This has created a strong resentment on the part of interior producers and exporters who are responsible for about 80 percent of the Chinese foreign exchange earnings.

5. All firms in Xiamen are exempted from duties, consolidated tax and licensing procedures for importing capital goods, intermediate goods and raw materials for use in export production. Exemption is also granted for a reasonable quantity of imported consumer goods for their own consumption (but wine, spirit, cigarettes and cosmetics only get 50% exemption). However, there is no effective way at present to prevent the zone enterprises from smuggling or reselling these duty-free imported goods, particularly luxurious consumer goods, into the interior market since the second customs border separating the SEZ from the interior is not yet set up.

6. Products manufactured by the FIEs or domestic-associated enterprises in Xiamen may be sold to the domestic market in *appropriate* proportion, provided they 1) provide China with advanced technology and equipment, or 2) replace

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[6]. According to the Regulation of the Xiamen SEZ, any product which is added more than 20 percent value in the SEZ will be regarded as the SEZ's product, and subsequently the foreign exchange earned from the export of this product will be shared between the SEZ's and inland partners at the ratio of 80:20 or 90:10.

the products currently imported by China, or 3) use a large proportion of local raw materials/parts/components. As these conditions are defined very loosely, the zone firms can always find some loopholes in them and get outlets for their illicit products in the domestic market.

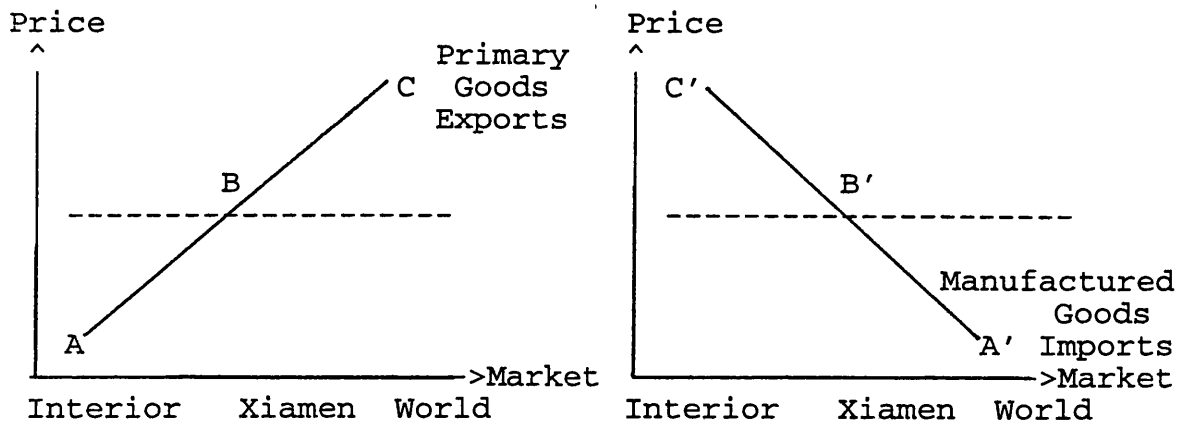
7-3. Policy Distortions and the Trade Problems

The above discussion tells us that the price reform in Xiamen has produced a new price system which is dominated largely by market forces. However, the impact of the new system on the operation of foreign trade has been compounded by the simultaneous and vigorous implementation of the Special Policy in the SEZ. Thus, in order to resolve the foreign trade problems identified in Section 7-1, it is important to find out the reasons for the problems in the context of the price reform and the Special Policy, or more specifically, to explore the relationship between the price reform and the Special Policy on the one hand and the trade problems on the other.

By combining Figure 7-2.2 with 7-2.3, the derived figure, Figure 7-3.1, reflects the fundamental price trend and pricing policy in the Xiamen SEZ and can therefore be used to explore the crucial relationship[7].

[7]. Figure 7-3.1 only shows the price trend for primary and manufactured goods in Xiamen and the pricing policy for exports and imports implemented by the SEZ authorities. It should not therefore be understood as that all exports from Xiamen are primary goods and all imports into the SEZ manufactured goods. For the actual commodity composition of exports and imports, see Table 7-1.1 and 7-1.2.

Figure 7-3.1 The price differentiations between primary and manufactured goods, and between exports and imports in the interior, Xiamen and world markets



Sources: Figure 7-2.2 and 7-2.3.

As shown in Figure 7-3.1a, line ABC represents the price level for primary goods in the interior, Xiamen and world markets, and the pricing policy for exports implemented in Xiamen. It indicates that it is generally profitable for Xiamen to export primary goods since it can get these goods from the domestic market at lower prices (between A and B) and sell them in the world market at higher prices (between B and C). This incentive structure explains, to a large extent, the following phenomena:

1). Why the share of the primary goods in total exports has remained high (48.02% in 1989, see Table 7-1.1), despite the long-standing official policy calling for the export of more manufactured goods. Table 7-1.1 seems to show a significant improvement in the share of light industrial products and textile (from 4.39% and 0.47% in 1985 to 28.55% and 10.52% in 1989, respectively), but it is an open knowledge that the *gross* export figures of the Chinese SEZs should be treated cautiously since they contain a considerable part of imported contents, with little domestic value added[8]. In fact,

[8]. The Xiamen authorities have declined my request for the data regarding the imported contents in their gross export figures. However, Table 7-1.2 clearly shows that the share of

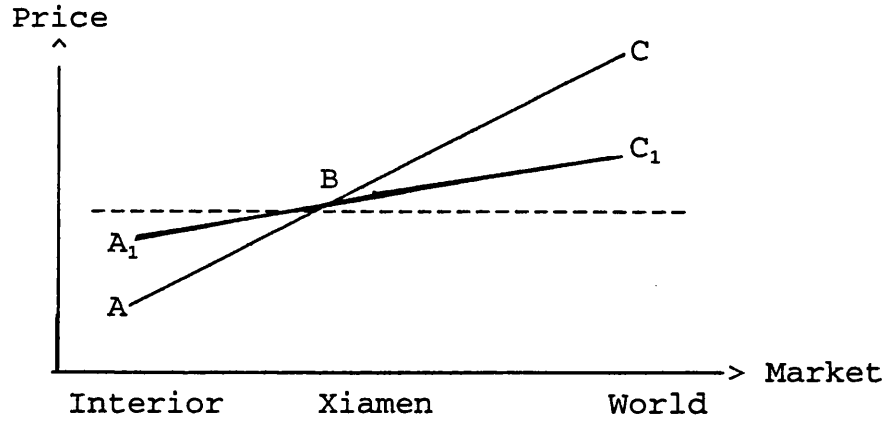
the share of machinery and equipment actually dropped from 5.35 percent in 1985 to 4.84 percent in 1988 and to 4.55 percent in 1989. This certainly had a lot to do with the price policy favouring the export of primary goods.

2). Why there has been a shortage of export supplies, especially agricultural, animal, native and sideline products, in Xiamen. It is much more profitable for domestic producers and traders to export these products directly rather than to sell them to Xiamen for processing or further processing (because C>B). Thus many interior regions were reluctant to trade with the SEZ unless other incentives were offered to them. As a result, the SEZ accused them of "shielding domestic markets from competition" while they attacked the SEZ for "making profits through exploiting interior regions" (*XMRB*, 10/1/88: 2). This has created a sharp conflict between the Xiamen SEZ and interior regions in the sharing of export profits.

3). How it was possible for the zone firms to engage in the "parallel trade." This can be explained by the fact that world prices for most primary goods are much higher than those in the Chinese domestic market (C>A), which has provided a big margin for the zone firms to wage a price war among themselves both in securing export supplies and selling goods overseas. This price war can be illustrated by Figure 7-3.2: where firms compete with each other by, on the one hand, raising their procurement prices well above the domestic prices in obtaining export supplies from domestic suppliers ($A->A_1$) and, on the other hand, slashing their selling prices in the world market well below the normal level ($C->C_1$), provided that they could still make some profits (i.e. as long as $C_1>A_1$).

Light Industrial Products in Xiamen's total imports jumped from 8.71% in 1985 to 21.01% in 1989.

Figure 7-3.2 How the "Parallel Trade" took place in Xiamen

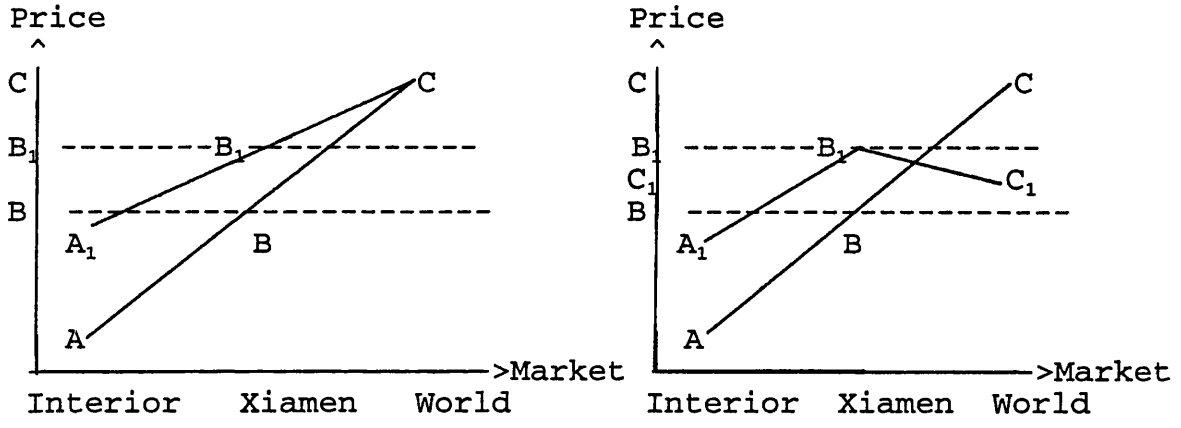


Of course, such "cut-throat" competition has not only seriously disrupted the normal supply-demand plans for export goods in the domestic market, but also, where foreign demand is price inelastic, led to losses for the country as a whole (Research Office, 1989: 166). The case of tinned mushroom mentioned in Section 7-1 has illustrated this point. Lack of co-ordination between the price reform (which allows the zone firms to set prices for their own business operations) and the Special Policy (which gives them unlimited access to both the domestic and foreign markets) seemed to be responsible for this problem.

4). Why many of the zone firms have suffered from high export costs and even losses. As can be seen from Figure 7-3.3, with the zone firms buying export supplies in the domestic market at higher and higher prices ($A->A_1$), the costs of their exports go up steadily ($B->B_1$). The high procurement prices are the result not only of "cut-throat" competition but also of increasingly strong demands for exportable goods (especially daily consumer goods) for local consumption in both the domestic and zone markets. As a result, many Xiamen firms has run into deep financial trouble owing to their inability to absorb the high costs. Figure 7-3.3a shows a substantial reduction in profits (from BC to B_1C) if prices for those export goods in the world market remain unchanged, while Figure 7-3.3b reflects a net loss in profits ($C_1<B_1$) if the world prices decline ($C->C_1$), which, unfortunately,

happened quite often due to the irrational competition and/or stagnant demand in the world market for the primary goods. Thus, both cases have resulted in serious economic losses for Xiamen trading firms.

Figure 7-3.3 How economic losses incurred in Xiamen's export operations



5). How loss-making firms in Xiamen have been able to sustain business without receiving substantial government subsidies, as their domestic counterparts often did. As explained above, the zone firms, domestic- or foreign-involved, are entitled to retain *all* foreign exchange earnings they made from exports, and to sell their unused foreign exchanges through the swapping centre at the adjusted price, which is normally 20-25 percent higher than the official exchange rate[9]. This means that the zone firms generally had more circulating capital for their business operations than domestic trading firms do. At the same time, consumer funds in Xiamen have grown expanded rapidly due to huge pay rises for the existing zone workers and staff and to the massive presence of immigrant workers engaged in capital constructions. These two elements have, as shown in Figure 7-3.4, sharply pushed up local prices of both producer and

[9]. In fact, it is a widespread practice for many zone firms to sell their foreign exchange through black markets and/or other illegal channels in order to gain more RMB cashes.

consumer goods (moving up line B_aB_b to $B_a'B_b'$ level) and hence led to a rampant inflation in Xiamen (higher than both Fujian's and China's levels, see Figure 7-2.1). As a result, the zone firms had to offer extremely high prices to purchase export supplies and thus pushed up the general price level in the domestic market (moving A up to A_1), transmitting trade-induced inflation into the domestic economy. This indicates that it is the *Special Policy* which has given the zone firms the financial resources to compete with domestic firms and hence to sustain business without receiving government subsidies.

Figure 7-3.4 How Xiamen firms compete favourably with domestic firms and transmit inflation into the domestic economy

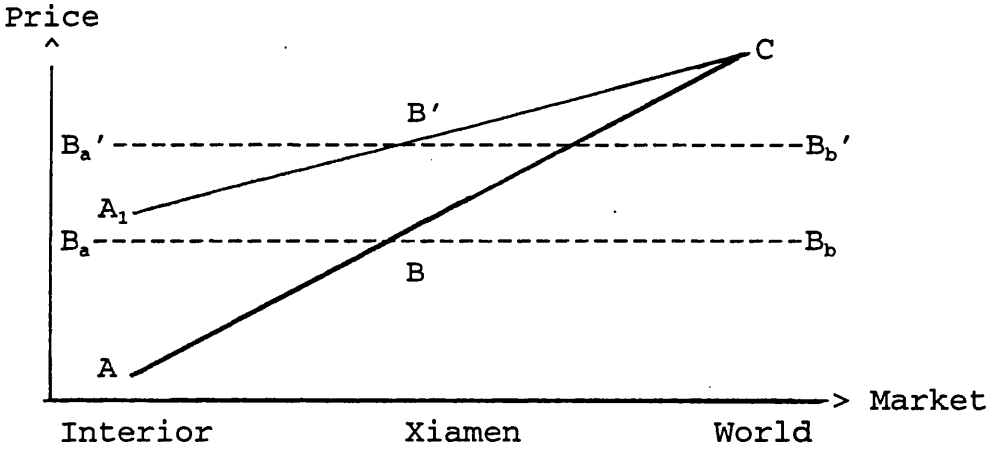


Figure 7-3.1b, on the other hand, tells the other side of story. Line A'B'C' shows the price level for manufactured goods in the interior, Xiamen and world markets, and the pricing policy for imports in the SEZ. It demonstrates that it is generally beneficial for Xiamen to import manufactured goods as it can import them at relatively low prices (A'<B'). This is especially true since, in the light of the Special Policy, most manufactured imports are exempt from duties, consolidated tax and licensing procedures (i.e. lowering B' level towards A'), provided they are used for export production. This, to a large extent, explains:

1). Why manufactured inputs, particularly the spare parts and components for assembling lines, has constituted the

overwhelming share of Xiamen's total imports (nearly 80% in 1989, see Table 7-1.2). For example, medical and chemical, light industrial, and precision instrument industries recorded a sharp increase in the share of their imported inputs over the period of 1985-1989 (from 1.56% to 25.98%, 8.71% to 21.01% and from 0.12% to 10.66%, respectively, see Table 7-1.2). This has further reinforced the view that the gross data of Xiamen's manufactured exports must be treated with a great caution, since it does *not* reflect the true level of Xiamen's own export manufacturing capacity.

2). How the "foreign exchange bottleneck" and the severe shortage of domestic inputs supplemental to FIEs in Xiamen have been created and indeed exacerbated. With the fast growth of manufactured imports, manufacturing sectors, particularly those mainly relying on imported inputs, have expanded quickly. In fact, there has been a tendency that the imported components in the total output of many zone firms became bigger and bigger (Meng Zen, 1989: 51). This has created two pressing problems: the first was the shortage of foreign exchange because the growth of foreign exchange incomes lagged far behind the increase in expenditures; the second was the acute shortage of domestic inputs supplemental to the fast growing foreign-invested processing or assembling workshops, particularly power, water, transport and telecommunication facilities. That is to say, uncontrolled expansion of imported manufacturing/processing/assembling capacities has excessively absorbed up Xiamen's already scarce financial (including foreign exchange) and physical resources.

3). Why many of the zone firms have tried to sell their manufactured products to the domestic market, instead of exporting them. Obviously, the higher price level in the protected domestic market for manufactured goods has been the key reason (C'>B'). This is particularly true at the present since the majority of Xiamen's products are not yet internationally competitive. Also, the strong demand for consumer goods, especially the zone-produced/assembled luxurious goods with imported parts and components, has

provided the zone firms with a great motivation to sell their products to domestic consumers. As a result, many Xiamen firms tried to seek quotas of domestic sales for their products by taking advantage of the loopholes in the Special Policy (see Section 7-2), such as giving false information about their export volumes, level and type of the technologies and/or equipment under which their products had been manufactured (ibid: 53). Clearly, the ill-defined Special Policy has been largely responsible for the large scale of domestic sales.

Even in the case of manufactured imports, it is still profitable to sell them to the domestic market as long as the zone firms can succeed in evading the normal import duty and the consolidated tax levied on the domestic sales of imported goods (gaining most part of difference between C' and B'). Indeed, quite a number of the zone firms have managed to do so by selling manufactured imports, such as vehicles, air-conditioners, colour TV and video recorders, to their interior partner(s) in economic associations in the name of "internal technology transfer" (Zhang Xie and Liu Xinhua, 1986: 36).

While line A'B'C' in Figure 7-3.1b tells us that manufactured goods in the Xiamen SEZ are generally more expensive than in the world market (B'>A'), line ABC in Figure 7-3.1a reflects the SEZ authorities' pricing policy for exports that allows them to be cheaper in Xiamen than in the world market (C>B). Together, Figure 7-3.1 explains why Xiamen has made losses by unduly encouraging the exports of its manufactured outputs. In order to achieve this, the authorities have not only continued to supply the export producers with cheap raw materials, energy and credits but also, more significantly, set up a special fund to subsidize the prices of manufactured exports, with a view to overcoming the disadvantage of high cost of production (Research Office 1989: 176-7) (i.e. making B' close to or even lower than A'). As a result, despite the fact that Xiamen's manufactured exports have increased markedly in recent years, financial losses have also gone up steadily and, indeed, become a heavy burden on the SEZ government (Chen Guangchong, 1988: 38). It

is therefore fair to say that the new price trend and pricing policy created by the price reform and the Special Policy of promoting exports of manufactured goods, have brought about substantial economic costs as well as achievements to Xiamen's export development.

To sum up, the price reform has empowered the zone firms to set prices for their own business operations, created price differences for primary and manufactured goods, and implemented a differential pricing policy for exports and imports between the interior, Xiamen and world markets. At the same time, the Special Policy has allowed the firms to deal in almost any goods they judge profitable, and granted them accesses to both the overseas and domestic markets. Xiamen firms were also encouraged to develop a variety of economic links with domestic firms in order to "strengthen the SEZ's capacity to absorb more foreign investment" and to "facilitate technology transfer into the hinterland." Under this regime, it is hard to prevent the zone firms from making use of their links with the highly protected domestic economy to engage in the "parallel trade" and large-scale domestic sales. These activities have led to sharp conflicts between Xiamen and interior regions, serious economic inefficiency in external dealings, and rampant inflation both in the SEZ and interior regions.

Thus, it is the *lack of coordination* between the domestic economic reform and the foreign trade liberalization, or more specifically, the price reform and the implementation of the Special Policy, which has been the fundamental reason for the problems in Xiamen's foreign trade performance.

7-4. Trade Development and Inflation

Experience in some developing countries, especially those undergoing the transition from import-substitute to export-oriented development strategy, shows that trade liberalization tends to start when the economy already exhibits serious

macroeconomic disequilibrium, such as severe foreign exchange shortages and high inflation as a result of large government deficits and devaluations[10]. In Xiamen's case, we have already demonstrated that the SEZ has suffered from both severe foreign exchange shortages and high inflation.

The reasons for macroeconomic disequilibrium in Xiamen are, however, much more complicated than those observed in the developing countries. As far as the inflation is concerned, this was caused not only by the successive devaluations of RMB since the late 1970s and early 1980s and the huge government deficits, but also by other radical domestic economic reforms, chiefly the price and wage reforms. As examined above, the drastic decentralization of the price management system, together with the implementation of the Special Policy, in the SEZ triggered off the inflation, particularly in 1985, 1988 and 1989 (See Figure 7-2.1).[11]

The inflation level has also been strongly influenced by the rapid expansion of foreign trade (exports and imports) in recent years. Table 7-4.1 shows that year to year fluctuations in the *Domestic Retail Price Index* are closely and positively related to the fluctuations in the growth of the *Total Volume of Foreign Trade* (over the previous year). Figure 7-4.1 demonstrates more clearly that the price index goes up (down) with the expansion (contraction) of foreign trade, though the latter fluctuating with bigger amplitude than the former.

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[10]. See Dornbusch and Helmers eds. (1988), chiefly, Chapter 10.

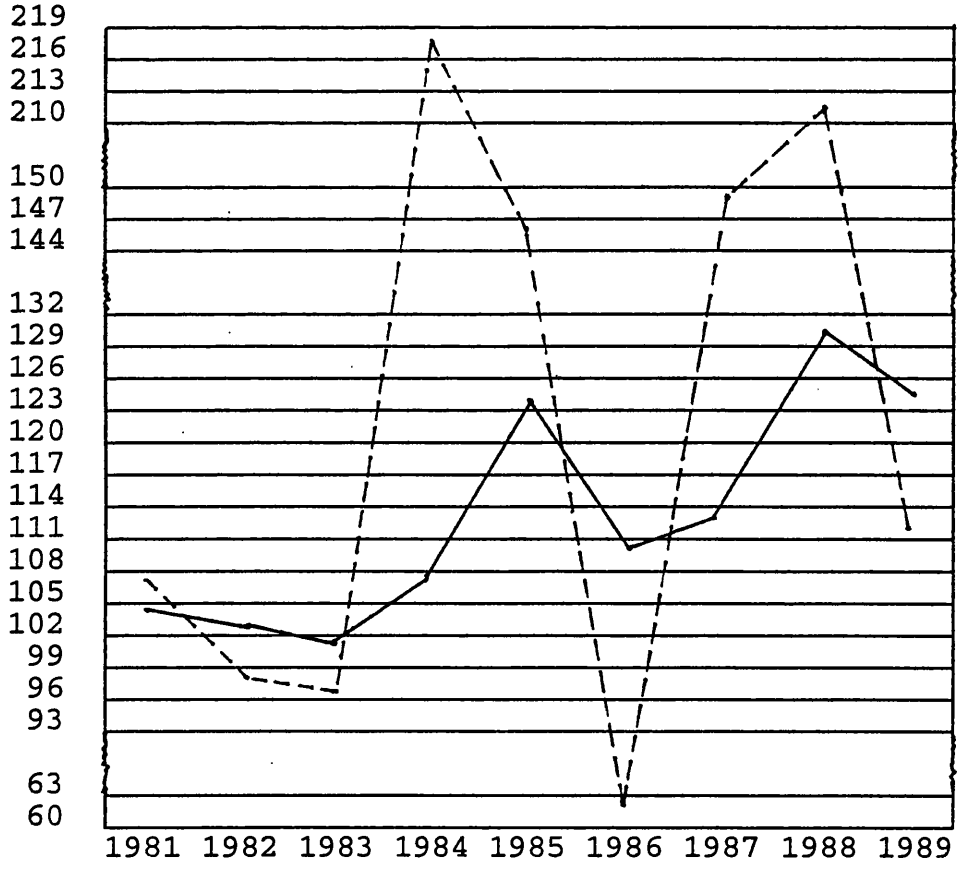
[11]. According to Harding, the Chinese policy-makers have learned the lesson that "price reform is highly inflationary unless it is conducted during a period of relative equilibrium between supply and demand" (1992: 84).

Table 7-4.1 The Domestic Retail Price Index and growth rates of total volume of foreign trade in Xiamen (1981 - 1989) (%)

	1981	1982	1983	1984	1985	1986	1987	1988	1989
Price index	104.7	102.6	101.9	107.2	123.1	109.8	111.9	130.1	124.8
Growth rate of foreign trade	107.1	97.3	95.0	217.2	146.1	62.7	149.4	210.2	111.2

Sources: 1). The price indexes: 1981-85: AXSEZ Editorial Board (1986), p. 91;
1986: XSB (1987), p. 340;
1987: XSB (1988), p. 320;
1988: XSB (1989), p. 352;
1989: AXSEZ Editorial Board (1990), p. 307;
2). The growth rates: the AXSEZ Editorial Board (1986), p.94; (1990), p. 324.

Figure 7-4.1 Trend of the price index and growth rates of foreign trade in Xiamen (1981-1989) (%)



Key: ——— Price index; ----- Growth rate of foreign trade

Source: Table 7-4.1.

The purpose of this section is to provide an empirical test of the above observation --- inflation is closely and positively related to the expansion of foreign trade in Xiamen.

John C. Hsu (1989) has made an elaborate study on the relationship in China in both pre- and post-reform periods[12]. By adopting the purchasing power imbalance approach[13], he concludes that foreign trade growth has had a significant effect on the degree of consumer goods imbalance in China. An increase or a decrease in foreign trade would, he argues, increase or decrease trade-induced demand for domestic goods, cause an increase or a decrease in the ratio of money incomes to consumption expenditure (*MI/C*), and hence signify a deterioration or an improvement in inflation rate (Hsu, 1989: 160).

In Xiamen's case, however, one cannot use the *MI/C* ratio as an indicator of the degree of inflation. This is because a considerable part of the *consumption expenditure* in the SEZ does not come from the local *money incomes*, but from the externally originated incomes brought in by the increasing number of floating population and tourists from other parts of and indeed outside China. Instead, we choose to use the Domestic Retail Price Index (*PI*), which is, according to the official definition, a weighted mean of the price indexes of goods and services purchased by both urban and rural people from both public and private sectors[14]. Clearly, when the *PI* goes down (up) it signifies an increase (decrease) in the purchasing power of people's money incomes. The question to ask is therefore: Will the *PI* increase (decrease) with an increase (decrease) in the relative importance of foreign

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[12]. See Hsu (1989), chiefly Chapter 4 and 5.

[13]. According to this approach, a rise or fall in the money incomes-consumption expenditure ratio, *MI/C*, indicates a deterioration or an improvement in consumer goods imbalance. See Hsu (1989), pp. 151-5.

[14]. Sometimes it is also called as the Whole-Society Retail Price Index.

trade in national output?

To carry out the test, we first list the PI for each year from 1970 to 1989, using the officially published statistics (see Table 7-4.2). Then, we turn to the estimation of the relative importance of foreign trade in national output. The trade-GNP ratio is one of the most frequently used indicators of the relative importance of foreign trade in the economy. In general, the greater the ratio, the more dependent is the economy on foreign trade. However, what is required here is an indicator which can reflect the relative size of trade-induced demand for domestic goods. We therefore decide to adopt the same approach as Hsu did --- finding out the trade-induced demand for domestic goods (T) first, then dividing T by national output (Y), and thus yielding the required indicator of the relative importance of foreign trade in national output. The T is set as

$$T = (X'' - M'') + \lambda M^* + X^* = X - M'' + \lambda M^*,$$

where X'' is consumer goods exports, M'' is consumer goods imports, M^* is producer goods imports, X^* is producer goods exports, $X = X'' + X^*$, and λ is a multiplier representing the amount of domestically produced producer goods needed to work with a unit of imported producer goods. To estimate M'' and M^*, we use the Renminbi value of imports, multiplied by the proportions of consumer goods and producer goods in total imports as published in the official statistical yearbooks. λ is estimated to be 2.3 (Zhou Yunyuan, 1987).

The above equation states that the trade-induced demand for imports is equal to net consumer goods exports plus producer goods exports plus the amount of domestically produced producer goods working with imported producer goods. We again use the official national income statistics for Y. The resultant T/Y ratios are also listed in Table 7-4.2.

Table 7-4.2 The price indexes and foreign trade-national output ratio in Xiamen (1970 - 1989) (%)

Year	*PI*(%)	*T/Y*
1970	98.4	0.0913
1971	100.0	0.1027
1972	100.7	0.0998
1973	100.1	0.1006
1974	99.8	0.0946
1975	100.1	0.1073
1976	100.2	0.1141
1977	100.1	0.0996
1978	100.3	0.1207
1979	102.9	0.1507
1980	103.2	0.1742
1981	104.7	0.1847
1982	102.6	0.1791
1983	101.9	0.1812
1984	107.2	0.2481
1985	123.1	0.3076
1986	109.8	0.2105
1987	111.9	0.3058
1988	130.1	0.3803
1989	124.8	0.3567

Sources: 1). 1970-80: XSB (1980), pp. 281 & 258;
2). 1981-89: *PI*, Table 7-4.1;
3). 1981-85: *T/Y*, the AXSEZ Editorial Board (1986), p. 94;
1986-89: the AXSEZ Editorial Board (1990), p. 324.

To determine the extent to which the level of the price index has been influenced by the growth of foreign trade, we regress *PI* on *T/Y*, using the ordinary least squares method. The regression results are given as follows[15]:

$$PI = 88.92 + 95.19\ T/Y,$$
$$(57.073)\quad (12.333)$$
$$R^2 = 0.894, \quad D - W = 1.8202.$$

Figures in parentheses are *t* statistics, R^2 is Predictive Ability Score, and *D - W* refers to Durbin-Watson Statistics.

These results show that the coefficient of *T/Y* is of the correct sign, both coefficients are significant, the Durbin-

[15]. For details of the calculation, see Appendix F.

Watson statistics indicates the absence of auto-correlation, and the R^2 statistics is almost 90 percent. They reveal that from 1970 to 1989 foreign trade growth had a significant influence on the level of the price index in Xiamen.

This result tells us the following causal link: an expansion of foreign trade will raise the level of investment at the expense of current consumption; the growth of investment will require a greater labour input, hence raising the wage bill; and the tendency for the investment growth to be biased in favour of producer goods production, especially infrastructure construction, will further aggravate the shortage of consumer goods. Such an effect will, according to Hsu, occur irrespective of whether imports of investment goods are financed by consumer goods or producer goods exports (Hsu, 1989: 145). In the prereform, centrally planned economy, the effect would take the form of an increase in repressed inflation, but under the economic reform and the Special Policy (or in the presence of free markets), the effect will manifest itself, at least in part, as open inflation.

Inflation does not take place only in Xiamen. In fact, many economies, in the process of liberalization, are often plagued by double- or even triple-digit inflation. This is because the policy adopted to tackle one set of problems frequently exacerbate another set. For example, a price reform may lead to a sharp price rise and hence overvaluation of domestic currency in the short run, while a devaluation may worsen inflation.

It is therefore necessary to link the maintenance of the liberalization process with the choice of stabilization policies. One of key reasons for the foreign trade problems in Xiamen has been that its reform packages only contained liberalization policies but no stabilization measures. Thus when inflation gets out of control and macroeconomic environment deteriorates, a austerity policy would be imposed by the central government, and the SEZ economy would then cycle back to an earlier, less liberalized phase.

7-5. Conclusions

The experience of trade liberalization in many developing countries shows that the *transition strategy* from a previously centralized and closed economic system to a decentralized and open one, is more important than the choice of the final objective of the reform. This is due to the general equilibrium (or disequilibrium) nature of economic interdependence and the fact that speeds of adjustment in various markets differ. In particular, because reform usually starts when the economy has serious macro imbalances, such as foreign exchange shortages and high inflation, it is essential for the reform policy to contain both a long-term market liberalization strategy to promote more efficient resource allocation, and short-run stabilization programme to reduce inflation and balance of payments difficulties (Bruno, 1988: 223-4).

Having realized the difficulty and complexity of the trade reform, the Xiamen authorities specifically called for "close coordination between the trade reform and price, tariff, enterprise and financial reforms" (Research Office, 1989: 176-7). Why, therefore, was there such a lack of policy consistency and coordination between the trade reform and the price reform in the SEZ?

There seemed to be four major reasons. First, the trade reform, as an indispensable part of the overall economic reform, should be conducted in parallel with various internal economic reforms, especially the price reform. However, like the reform in the Chinese domestic economy, Xiamen has found it easier to develop trade links with the outside world than to reform the old, Soviet-style economic system. In other words, the Xiamen authorities tried to use foreign trade and investment to side-step the hard choice of the economic reform. As a result, the trade reform became "one-step ahead of" the domestic economic reform and in fact was implemented while the distortions of the economy remained largely uncorrected. The consequence has been that authority,

responsibility and economic interests were not integrated properly either in governmental organizations or trading companies. This can to a large degree explain why the chaos took place as soon as the decentralizations were carried out. As a result, it was hard for the government to design an effective macroeconomic policy to regulate decentralized trading operations. Instead, it ended up with no option but to regulate different products, sectors, localities and enterprises on an *ad hoc* basis, relying on elaborate policies and measures normally mixing administrative means and economic levers.

In fact, the World Bank has pointed out in one of its country reports that when domestic prices, taxes, wages and interest rates are still distorted the devolution of export and import decision-making powers to enterprises could "result in inappropriate trade pattern and even in trade and balance of payment difficulties." It urged that the trade reform should proceed "in parallel with internal economic reforms" (World Bank, 1985: 100-1). Unfortunately, the Xiamen (and indeed the Chinese) authorities have either ignored or been unable to implement this crucial advice.

Second, the price reform includes the adjustments of the foreign exchange rate and tariffs, which are central to the success of a trade reform. Though China has successively depreciated its exchange rate since the late 1970s, the ever increasing domestic production costs and hence inflation has offset the effect of the devaluations, leaving the distortion in the exchange rate largely uncorrected. Although the tariff reform has been carried out more radically in the SEZ than in interior China as a whole, Xiamen is still a partially protected area, as indicated by the existence of the "two-ladder-price" and the "two-way-slope"pricing policy. This indicates that the price reform has done little to reverse the old incentive structure which tends to bias against export. That is to say, Xiamen is "far from creating a neutral trade incentive system" (Zhou Xiaochuan, 1988: 23), one of important goals of the trade liberalization.

Third, the Special Policy was also responsible for the problem. Despite the fact that the CRS and later the STP scheme have been widely introduced in zone firms to harden their financial constraints, the firms were still able to expand and compete by bidding up costs because they were all subsidised, in one way or another, by the Special Policy (i.e. through exemption from or reduction in taxes and tariffs, and foreign exchange retention and sales etc.). In other words, the trade reform still lacked an appropriate microeconomic foundation.

And finally, the close link with the domestic economy has been a major reason. While Xiamen was authorized to go "one step ahead of the domestic economy" in carrying out the trade liberalization and other radical economic reforms, it was also encouraged to develop a variety of economic links with the domestic economy, which is still largely centralized and protected. As examined in previous sections, the reliance of Xiamen on the domestic economy to get export input supplies and to sell a part of its outputs has made it very vulnerable to the domestic economic cycle.

At the same time, the rapid proliferation of a variety of domestic economic associations in Xiamen has, while greatly enhancing the SEZ's capacity to manufacture and export more competitive products, brought many aspects of the less-reformed domestic economic elements into the SEZ, reinforced the old economic system and policy, and thus retarded the speed of the development of a new and open economy in the SEZ. As a result, the conflicts between the old, centralized, inward-looking regime and the new, market-based, export-oriented approach, between sectors, regions and enterprises, and indeed between the SEZ and the domestic economy as a whole have inevitably been intensified.

Thus, as far as the relationship between the Xiamen SEZ and the domestic economy is concerned, it is the close institutional links between the two which has caused the problem of policy inconsistency, ambiguity and unpredictability in the Xiamen SEZ. Despite the implementation

of the Special Policy and the heavy presence of foreign capital, the foreign trade and price reforms in Xiamen have not been coordinated properly and produced any innovative results which could benefit the national trade and price reforms.

Thus, it is clear that how to deal with the relationship between the Xiamen SEZ and the domestic economy, or more specifically, how to, on the one hand, maintain and enhance the normal economic links with the domestic market and, on the other hand, to lessen and sever the institutional connections with the domestic economic system, holds the key to the success of the export-oriented outward-looking economy in Xiamen.

CHAPTER 8
SUMMARY AND CONCLUSIONS

Having experienced as a commercial seaport for more than three centuries, then a closed coastal industrial city for three decades and now a SEZ, Xiamen is clearly entering a new stage of development. It faces unique and formidable challenges: reforming the old, centrally planned economic regime at the same time as building a new, market-based system; combining the transformation of the outmoded industrial structure and inefficient enterprises with the utilization of FDI; developing an industry-oriented SEZ in the short run and a FTP in the long run; strengthening its links with the interior economy while developing its own export-oriented outward-looking economic mode; and implementing the Special Policy on the one hand and creating some instrumental and applicable experiences for the domestic economic reform on the other.

Although the problems Xiamen has encountered are not uncommon in other developing countries, EPZ-type economic zones and reforming socialist economies, the challenges it faces are certainly unprecedented in its system-wide scope, its political and historical context, its impacts on China's economic reform and "open-door," and its far-reaching implications for the development of the economic cooperation between the PRC and Taiwan and indeed the formation of the "Greater China Economic Areas."

This thesis has explored two important issues untouched in the previous researches on China's SEZs --- the reasons for the problem of policy inconsistency, ambiguity and unpredictability in the Xiamen SEZ and the assessment of the

effectiveness and significance of the SEZ serving as a "laboratory" for the domestic economic reform. It has approached the issues from a new perspective --- the interactions between the Special Policy and the economic reform, between the local economic development and FDI (especially TDI), and between the SEZ and the domestic economy.

Chapter 5, taking a micro view and examining the enterprise reform in Xiamen, concludes that it is the confusion of a real economic reform and the implementation of the Special Policy and, in some cases, the substitution of the former with the latter which has been largely responsible for the problem in Xiamen's reform policy.

Chapter 6, taking a macro view and investigating the effects of FDI, especially TDI, on Ximen's industrial transformation, concludes that it is the increasing domination of Taiwan capital in Xiamen's foreign economic scene which has induced the local authorities to change, or change the emphasis of, their industrial development priority and plan and thus caused the problem in Xiamen's industrial development policy.

Chapter 7, taking an overall view and exploring the relationship between the foreign trade liberalization and the price reform in Xiamen, concludes that it is the close institutional links between the Xiamen SEZ and the domestic economy which has made the former very vulnerable to the latter's recurrent fluctuations, especially the boom-bust cycle, and should therefore be seen as the major reason for the problem of policy inconsistency, ambiguity and unpredictability in Xiamen.

China is now at a critical stage --- the coexistence of the old, closed and the new, open economic systems, which means that the two systems are functioning simultaneously in the economy. This obviously makes the reform and "open-door" more difficult and complicated. It is easy, therefore, to understand the importance of the experimental role the SEZs are expected to play. However, given the small size and high

labour-intensity of most of the FIEs in Xiamen the transferability of their experiences for improving the efficiency of generally larger SOEs in other parts of China seems to be very limited. Indeed, the analyses conducted in Chapter 5, 6 and 7 have overwhelmingly indicated that the experimental role played by the SEZ has been much less significant than originally anticipated. This implies that it is still too early, if not unrealistic, to ask the Chinese SEZs to perform the important and complex experimental function.

Apart from the above three crucial relationships, several other important issues have also emerged from the discussions in Chapter 5, 6 and 7. This final chapter is to make a brief summary of and draw further conclusions on them.

8-1-1. The Scheme of the Separation of Tax and Profits

Reform of SOEs is the centrepiece of the economic reform programme in almost all socialist and the formerly socialist economies. China's enterprise reform in the last decade or so failed to improve the productivity and efficiency of most of its SOEs because, as shown by the experience of the first-stage reform in Xiamen (see Section 5-2), the authorities were reluctant to terminate subsidies to the local SOEs, which were still the largest contributor to the government coffers.

According to Stepanek, the Chinese authorities' dependence on the income from SOEs creates a "crippling fear of innovation" in the enterprise reform policy (1992: 453). It is in this sense that the new STP scheme could be seen as Xiamen's indigenous and bold attempt to break the deadlock of the enterprise reform and tackle the deep-rooted problem --- soft budget constraints" --- embodied in its SOEs. As analyzed in Chapter 5, however, the overall result of the two-year reform (from 1988 to 1989) has been disappointing, despite the claim of success made by the local authorities.

Compared with previous reform packages, such as the Tax-for-Profits and the CRS, the design of the STP scheme seems to

have three potential advantages. First, by separating the profit tax and the after-tax profit delivery, it has resolved, in theory at least, a crucial problem which all the previous reform programmes, had failed to tackle --- the distinction between the state as tax collector and the state as owner of fixed assets. This should greatly enhance the government's ability to regulate the economy through the taxation policy and to manage the state-owned assets, both of which are vital for the success of China's enterprise reform. This could also offer China the best way to separate enterprise ownership and management --- the essence of the enterprise reform.

Second, the new 15 percent tax rate applies not only to foreign-invested firms but to the local Chinese ones as well. This is crucial for the removal of the distortions in financial rates of return and investments and the creation of a level playing field for the SOEs to compete with non-state enterprises, especially FIEs. At the same time, the abolition of the adjustment tax previously applied to the SOEs has contributed to introduce a more transparent treatment of enterprise taxes. China has been repeatedly urged to reform its enterprise tax system, in particular, to set up a non-negotiable and uniform direct tax regime (e.g. World Bank, 1988b: Chapter 9; Wood, 1991: 34; Singh, 1992: 82). Thus, Xiamen's action could be seen as an important step toward the establishment of a genuine and effective enterprise tax system in China.

Third, the provision that all enterprise loans should be repaid out of after-tax profits, instead of pre-tax profits, is generally seen as a more effective measure to induce enterprises to exercise more caution in using investment resources and thereby improve the efficiency of investment.[1] By making enterprises accountable to their investment decisions, it helps harden their financial constraints.

However, the STP scheme in Xiamen, just like similar contract plans implemented in public enterprises in many

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[1]. For the criticism of the pre-tax repayment of bank loans, see, for example, the World Bank (1988b), para. 68.

countries, had more problems "in implementation than in design" (Nellis, 1989: xv). Three problems are fundamental. First, the rate of after-tax profit delivery, which in fact served as a profit adjustment tax, was negotiated between the enterprises and their supervisory bureau on *ad hoc* base. The negotiable status of the rate enabled both enterprises and bureaucracies to manipulate the after-tax profitability and thereby influence the level of enterprises' retained profits independent of their underlying performance. As a result, similar enterprises may face quite different rates and other financial treatments. This is precisely the major defect of the CRS.

Second, the provision that enterprises are allowed to choose when and how much to repay their bank loans encouraged them to delay the repayment and diverted the funds to other purposes, notably bonuses and other welfare expenditures. Again, this is a typical defect of previous enterprise reform programmes (Byrd, 1992: 4-5 & 18). In Xiamen's case, the "softness" of this provision has almost, if not totally, offset the "toughness" supposed to be introduced by the change in the source of repaying bank loans (from pre-tax profits to after-tax profits). The Xiamen authorities apparently failed to understand that prohibiting excessive bonus and other welfare payments to SOE personnel and enforcing loan repayment on time are not only essential for hardening budget constraints on the enterprises but also, from macroeconomic point of view, a prerequisite for the effective use of interest rate and credit policy and hence the control of inflation. In fact, Xiamen's experience has reinforced the view that an incomplete enterprise reform will inevitably lead to macroeconomic instability (Woo *et al.*, 1993: 4).

Third, like the CRS, the STP scheme did not have an effective mechanism to prevent the director of enterprise, or the contractor, from maximizing the short-term profits of state-owned assets which he temporarily owns within the contract period. This was due to the fact that many agreements did not contain the provision which compels him to increase,

by certain degree, the value of the enterprise's fixed assets over the contract period. Besides, the STP scheme did not specify how to penalize poorly performed managers and enterprises failing to meet their targets. Bankruptcy never became a real threat to the SOEs, especially sizable ones. That is to say, the weak or reluctant defence of capital income by the SOE managers during the contract period has been the key reason for the relatively poor financial performance of the SOEs and the reduce in the government revenue in Xiamen in recent years. This has once again highlighted the importance of ownership reform.

In short, the STP scheme is an important policy innovation on the part of the Xiamen authorities. It moves from pre-tax to after-tax contracting, removing the direct tax out of negotiation, and could thus be regarded as an advanced form of the CRS. Obviously, it has, to some extent, increased the complexity and sophistication of China's tax system. However, like the CRS, it is also a negotiated performance agreement between the government and the enterprise. Further, it seemed, more often than not, to be used by various local interest groups --- workers, managers and the SEZ government --- to appropriate rents rather than as a mechanism to enhance enterprise accountability and improve productive efficiency, as indicated by the continuing increase in the scale of enterprise losses (see Table 5-4.4).[2] Experience in many developing countries suggests that contract-based performance agreements "have not improved the financial performance of public enterprises dramatically," especially, they are not effective in "healing a sick company" (Nellis, 1989: iii).

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[2]. Of course, the nature of semi-reformed price, financial and tax systems and the lack of coordination among the various reforms have also affected the effectiveness of the STP scheme.

8-1-2. Enterprise Association, Ownership Reform and Privatization

Apart from the heavy dependence of the authorities on the income from SOEs, another crucial factor which has hindered the Chinese enterprise reform from going further is the important *social functions* assumed by SOEs, which are generally obliged to provide health care, housing, education, entertainments and, in some cases, even scarce consumer goods to their employees. This means that to penalize a SOE for its poor performance would have serious social consequences in the absence of a nationwide social security net. That is why the Chinese authorities have been reluctant to apply the *Bankruptcy Law* to most loss-making SOEs and extremely cautious towards the implementation of ownership reform and privatization in the domestic economic reform.[3] Thus, how Xiamen takes advantage of its special status to carry out some radical ownership reforms and privatization programmes remains a great challenge to the SEZ authorities.

The STP scheme operated in the Xiamen SEZ, like the CRS implemented in elsewhere of China, is only a performance agreement negotiated between the government and the enterprise, with no private individuals or sectors being involved. It is therefore even not a preliminary form of privatization, let alone a ownership reform. Thus, it appears to accord with the basic principle of the Chinese enterprise reform --- separating government ownership and enterprise management while maintaining state ownership in most SOEs, especially sizeable ones (Dong Fureng, 1990: 68-9).

On the other hand, various forms of enterprise association, which flourished throughout 1980s largely as a result of industrial reorganization, have provided an unique

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[3]. The term of *Privatization* has many meanings. In this thesis, it refers to the general process involving the private sector in the ownership or operation of a SOE. That is to say, it covers both the private purchase of all or part of a SOE and the contracting-out of the management of a SOE, such as leases, management contracts, and franchise arrangements.

opportunity for Xiamen to experiment with some forms of ownership reform. While the association between the public sector and the private sector creates a new economic sector with mixed ownership, the nature of the association between public sectors, particularly between SOEs, however, is an interesting issue deserving a detailed discussion.

The constituent members of the SOE associations in Xiamen are different types of SOEs. Some are owned by various local governments while others by central ministries; some are manufacturers while others trading companies or financial institutions; and some are located locally while others from elsewhere of the country. Together they form a new mixture of state ownership, referred by some Chinese economists as "socialist enterprise ownership" (*Shehuizhuyi Qiye Suoyouzhi*). These associations are generally headed by a board of directors (*Dongshihui*). They could thus be seen as the embryonic form of the so-called socialist joint stock company --- a SOE owned by several different state institutions interested mainly in its profits --- envisaged by the World Bank and some Western economists for the Chinese enterprise reform (e.g. World Bank, 1985: 166; 1988b: Chapter 3; Wood, 1991: 38-9).

It is argued that such arrangement is possibly the most realistic and feasible way to restructuring the SOEs in China, given the fact that the dominant position of state ownership is, for political, economic and social reasons, unlikely to change in the foreseeable future. Compared with the old SOE, the new, associated enterprise seems to have two important advantages. 1) The enterprise management is interested not only in its short-term profits but also in the long-term change in the value of its assets, which is crucial for toughening its financial disciplines; and 2) As most of the associations are managed by the board of directors, the local government will find it hard to interfere in their business operations, as often happened in dealing with the SOEs implementing the STP scheme or other contract-based agreements. Having attracted a large number of interior SOEs

to come to the SEZ to form a variety of economic associations with the local SOEs, Xiamen definitely has a great role to play in pioneering this particular enterprise reform.

Of course, this does not mean that the proposed joint stock ownership is a perfect solution. Indeed, there is even no guarantee that it will succeed in the future reform, especially in view of the fact it provides no answers to all the problems related to SOEs' social functions. The World Bank admits that such solution "has no parallel elsewhere" (World Bank, 1985: 166).

At the moment, the development of the economic associations between SOEs in Xiamen still has some problems. For example, state assets and shares of few small SOEs experimenting limited privatization were substantially underpriced, especially when they were sold to their own employees. Some associations became new administrative organs set up to oversee their small members while others were engaged in illicit trade to take advantage of the Special Policy. Also, some members of boards of directors were selected because of their political influence instead of their professional competence.

These problems are not unusual. They simply reflect the distortions which are bound to arise when market reform is conducted in a piecemeal and uncoordinated way. What is important for the Xiamen authorities, however, is to understand that a simple dispersion or combination of the ownership and capital of the existing SOEs is not enough to eradicate the underlying problems in the SOEs. Instead, they should endeavour to reinforce the system in the long run by diversifying investment pattern and attracting more state institutions, especially state asset management bureaus, banks, insurance companies and pension funds, to acquire financial interests in existing and new enterprises. At the same time, they should collaborate with these institutions to build a comprehensive and effective social security system in order to free the SOEs from the responsibility of providing the multiple social services to their employees, thus paving

way for a more radical ownership reform and privatization.

In addition, Xiamen, as a SEZ, should make full use of foreign economic resources in pushing ahead its enterprise reform.[4] The local SOEs could be sold either outright or partially to foreign investors and thus become WFOEs or JEVs. As Xiamen still has not possessed a properly functioning capital market and the majority of the households there are not yet sufficiently rich and financially sophisticated, the method of *public offering of shares*, typically suitable for large and commercially sound enterprises, is clearly not an ideal option for Xiamen to implement privatization.[5]

However, the techniques of *private sale of shares, sale of assets*, and *new private investment* are clearly more suitable for Xiamen, where most of the SOEs are small- and medium-sized and unprofitable. These methods provide an attractive opportunity for private (including foreign, particularly Taiwanese) sectors and individuals to invest in Xiamen and to become whole or partial owners of previously SOEs, thus opening up a new dimension of ownership reform.

Similarly, the techniques of *lease* and *management contracts*, in which no transfer of ownership is involved, are an ideal way to introduce foreign industrial management expertise. The experiences of Hong Kong and Taiwan entrepreneurs in managing small- and medium-sized and relatively labour-intensive enterprises are among the best in the world, and Xiamen should maximize its special links with Taiwan in this regard. Of course, in the long run Xiamen

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[4]. For more detailed studies on the privatization of SOEs and various techniques it applies, see the World Bank (1988c). The terminology and classification used in the following text are those of the document.

[5]. The alleged "inside dealings" and other irregularities, which led to riots by hundreds of protesting share buyers, during the public offering of shares in the Shenzhen SEZ in the late 1992 seems to have vindicated this point.

For more arguments against rapid privatisation of SOEs via share issue in Soviet-type economies, see Nolan (1993), pp 182-3 & 292-4.

should use lease and management contracts only as an interim solution, particularly as a mechanism to restore failing enterprises to some form of health, and lay a foundation for a fully-fledged privatization in the future.

Thus, foreign involvement in Xiamen can not only bring in badly needed capital into the SOE sector but also, if guided properly, play an instrumental role in the ownership reform. It is undeniable fact that most of the foreign investors in Xiamen tended to sidestep the SOEs in seeking local partners because of their generally poor financial performances and market potentials. A recent World Bank study on foreign investment in China also finds that "improvements in productivity and efficiency were slow to come in joint ventures formed on the base of original SOEs" (Khan, 1991: 14). Thus, the Xiamen authorities must do everything they can to create a conducive economic, administrative and legal environment which will facilitate the participation of foreign private sectors and entrepreneurs in the process of the ownership reform and privatization.

8-2-1. Selection of Leading Industry and Linkage Effects

Obviously, it is important for the selection of leading industry to be based on the regular analyses of changes in the structure of world industry and its probable future evolution. Some authors argue that most developing countries tend to select the leading industry from established industries, the one which has most extensive linkage effects on, and hence can transmit biggest amount of stimuli to, other industries. In other words, it has to be on the existing technology frontier (e.g. Weiss, 1988: 319-21).[6]

Historical experiences in both mature and newly industrialized countries have proved the vital importance of the machinery sector, or capital goods sector, in the process

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[6]. For more detailed discussion of selecting the leading industry and of linkage effects, see Meier (1989), Chapter VI; and Weiss (1988), pp 319-21.

of industrialization due to its extensive technological external effects. It has not only played a key role in the industrial development of countries like the U.S.A. and Great Britain, but also enabled Japan to transform from a technology follower to a technology leader.[7] Developing countries with substantial capital goods sector, such as Brazil, India, South Korea and Taiwan, have also witnessed its dynamic contribution to their economic development.[8] Today, the machinery sector is essential for all countries to attain and indeed maintain international competitiveness because of its centrality in the generation and diffusion of technical and productivity change.

Compared with most developing countries, China is very fortunate to have possessed a relatively strong and diverse machinery sector and resourceful engineering skills, though as a legacy of the Soviet-type command economy. It would therefore be a "huge waste" if it disregards, intentionally or unintentionally, this well-established "advantage" (Nolan, 1993: 188-90) in deference to the development of new industries, such as electronics. A group of Chinese economists made, with the cooperations from the Chinese authorities and foreign experts, an elaborate study on the optimization of China's industrial structure. Using the technique of Analytical Hierarchy Process, they identify the machinery sector as the *number one* industry which should be designated for priority development.[9] There is no place for the electronics industry in all the 19 industries/sectors selected for priority development. But in order to "prepare China to rise to the challenge," they recommend the electronics industry, especially microelectronics, be developed side by

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[7]. For the Japanese experience in this regard, see OECD (1972).

[8]. Many authors have noted that important role. The World Bank and UNCTAD even undertook special surveys on the issue in several countries. See chiefly Fransman (1986), Little (1982) and Rosenberg (1976).

[9]. This seems to coincide with Nolan's view that Soviet-type economies should not "close" but "restructure" their heavy industry in the transition period (Nolan, 1993: 190).

side with the machinery industry (Yu Jingyuang *et al.*, 1993: 197-203).[10]

The Xiamen authorities justify their choice by arguing that the electronics industry is a modern, dynamic sector and has played a crucial role in stimulating the industrial development both in Western industrialized and, more recently, some successful developing economies. This may be true so far as the fact is concerned, but the authorities forget an important fact: Xiamen in the early and mid-1980s was substantially weaker than those economies when they started developing electronics, at least in terms of the overall industrial capacity and the level of R & D. This implies that the success in those countries will be hard, if not impossible, to be repeated in Xiamen. Indeed, the record of the development in the first decade, as shown in Chapter 6, has vindicated this prediction.

There is no doubt that China, as a developing country striving for industrialization, needs to develop a strong and internationally competitive electronics industry, which will sever as catalyst to the upgrading of its outmoded industries. What the Xiamen authorities need to understand is that there are many industrial cities or centres in China which posses far better conditions and indeed have already developed more advanced and efficient electronics industry. Over-ambitious development goal, as shown by the Chinese own experience in the last four decades, often leads to high economic costs and eventually the delay or even setback of the development.

The consequence of the ill choice of the leading sector in Xiamen has, as we see in Chapter 6, been the profound lack of linkage effects between the "leading industry" and others, and between most of the FIEs and the local enterprises. The so-called electronics industry, though growing fast, was in fact nothing more than a dozen of foreign-transplanted

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[10]. The first ten industries/sectors chosen for priority development are: machinery, agriculture, railway transport, ferrous metal, chemicals, petroleum, electricity, other transportation sectors and telecommunications, construction, and commerce. See Yu, *op cit.*

workshops/assembly lines, or more precisely, an enclave import-export industry.

In fact, Xiamen's case exemplifies a typical problem currently faced by China: many coastal cities and development zones have chosen electronics, microbiological engineering or other hi-tech industries as their development priority, regardless of local economic and technological conditions. Almost every of these open areas has built one or more hi-tech parks, vowing to become the centre of that technology in the country. This vividly reminds people of the Great Leap Forward campaign in the late 1950s, when almost every town and village in China built one or more steel mills, considered to be essential to the industrialization of China at that time. The result of the campaign was of course disastrous to China.

It is, therefore, high time for the Chinese authorities to, on the one hand, modify the country's development strategy for electronics and, on the other hand, transform the old machinery industry into a dynamic manufacturing force which will stimulate the innovations in other industries and thus generate a sustained economic growth. In other words, they should formulate a new industrial development policy which, as recommended by the World Bank study, should include "targeting of priority industries" and the development of "backward and forward linkages (...) in conjunction with foreign invested projects" (Khan, 1991: 25).

8-2-2. Enclave Characteristics of FDI and Dual Economy

The enclave characteristics of FDI in the Xiamen SEZ is not uncommon in other EPZ-type economic zones. In fact, UNCTAD (1985) reveals that linkages between most of the EPZ firms and the local economies "have not as a rule been created." The main reason is the "bias implicit in the EPZ device in favour of import-intensive operations" (p. 17).[11]

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[11]. Some scholars argue that the enclave nature of EPZ operations in developing country is in fact one of major attractions to foreign investors. See, for example, T. Takeo

Experiences in many developing countries have shown that the only way to integrate FDI into the development programmes of recipient country and safe-guard against enclave-type investment is to form a partnership between private foreign capital and local private or public capital. That is why East Asian countries "have placed high importance on the development of backward and forward linkages" through the partnership (Khan, 1991: 18). The new approach to FDI has, according to Gerald M. Meier, been "to focus on alternative arrangement for securing capital, management, technology, and marketing capabilities without the foreign ownership and control." As a result, the developing country has been strongly advised to forge the partnership through *contractual arrangements*, which can supply the needed foreign managerial and technological knowledge at a lower cost (Meier, 1989: 260-1). It is therefore sad to see that the shares of both CMEs and JEVs in total number of FIEs in Xiamen declined steeply from 1985 to 1989.

There were other factors exacerbating Xiamen's problem. First, in terms of the sectoral structure of FDI, the proportion of the electronics industry, which traditionally has very low propensity to use local inputs (Basile and Germidis, 1984: 48-49), has been too high, ranging from 75 to 85 percent (see Table 6-2.4). Other industries, such as textiles and clothing, food processing and toy manufacturing, have little chance of technology transfer (ibid: 51). On the other hand, the industries most likely to create linkage effects, such as capital goods and construction materials, only took negligible shares.

Second, more than three-quarters of FDI firms in Xiamen were WFOEs (see Table 6-2.7), most of which were vertically integrated into parent corporations overseas, and thus concerned with maintaining their own international production network rather than with setting up links with the local economy.

(1978).

Third, as the Xiamen SEZ is located in the remote and largely isolated Xiamen Island, characterized by the inadequacy of basic infrastructures in the island itself and of industrial development in the surrounding areas, it is difficult for the FIEs to develop sub-contracting activities with the local firms. Sub-contracting is widely regarded as the most effective way to break the 'enclave' of EPZ firms, penetrate the host economy, and thereby increase local value-added (ibid: 53-4).

As a result, Xiamen inevitably witnesses the phenomenon of dual economy, with new, dynamic FIEs, which manufacture light industrial/consumer goods largely for export, on the one hand, and old, stagnant or even declining local enterprises, which provide basic infrastructures or produce traditional necessities mainly for local consumption, on the other. Without doubt, this situation, if not rectified soon, will escalate social tensions and destabilize Xiamen's economy in the long run.

Thus, it is important for the Xiamen authorities to stop indiscriminately attracting FDI projects in pursuit of the *amount* of foreign capital and, where possible, negotiate to improve the terms on which the links between foreign and local firms can be established.

8-3-1. Trade Reform, Conflicts and Economic Inefficiency

With the operation of a largely decentralized foreign trade system and semi-reformed prices, Xiamen encountered a serious problem: sharp interest conflict between zone traders and interior producers/suppliers of export goods. The result of it is, as we have seen in Chapter 7, ferocious "trade wars" fought between traders themselves, and between traders and producers/suppliers. Two important issues can be raised from this problem.

First, the problem is unique to the Chinese economy. It is in fact conflicts between the Special Policy and the general economic policy, and between the new, decentralized

export-oriented system and the old, centralized import-substitute regime. To a large extent, it is the reflection of the traditional problem embedded in the Chinese central-planning system --- conflicts between regions and sectors and between coastal and interior regions. The Chinese had never solved the old problem due primarily to their failure to break the cycle of over-centralization - decentralization - chaos - re-centralization. The new problem seems, too, intractable so long as the economy remains partially reformed and the policy differentials exist among enterprises, regions and sectors.

Second, the problem has been the biggest source of economic inefficiency brought about by the trade liberalization in the SEZ. This can be explained by the following points: 1). it artificially increased the costs of export and import dealings; 2). it pushed up the rate of inflation in both the SEZ and interior regions; 3). it interrupted normal production and export plans and trading networks in the interior, leading to wastes; and 4). it encouraged illicit dealings and other forms of corruption.

Ii is important, therefore, for the Xiamen authorities to realize that the trade liberalization which instituted a multi-tier price system in the SEZ has created an environment which encourages speculation and corruption as much as profit seeking by the rational means of cutting costs and increasing factor productivity. Indeed, one can only hope that the static efficiency costs caused by the irrational trade competition will not totally offset the dynamic gains resulting from the trade decentralization in the SEZ.

8-3-2. Trade Reform and Macroeconomic Stabilization

The empirical test in Section 7-4 clearly reveals that increases in foreign trade in Xiamen during the decade of the 1980s raised, in every case, the rate of inflation. So does this vindicate the argument that trade liberalization and macroeconomic stabilization are incompatible? or, as argued strongly by some Chinese economists, that trade reform can

only be introduced after inflation is contained?

In fact, experience in many countries in the 1980s, except few with extremely high inflation, indicates that trade reform and stabilization can proceed in parallel successfully (Thomas and Nash, 1992: 44-5). Like other developing countries, Xiamen can also introduce some trade reforms, such as converting non-tariff barriers to tariffs and eliminating tariff exemptions, to increase government revenue, which is crucial for the reduction in the fiscal deficit, current account deficit, and hence the rate of inflation (ibid: 45). But these measures can only produce limited effects in Xiamen because the main structural reasons for the trade-induced inflation in Xiamen, as discussed in Section 7-4, are different from those in other developing countries.

According to Harding, China's recent experience with inflation was the predictable result of granting greater financial autonomy to localities and enterprises, without simultaneously subjecting them to hard budget constraints (1992: 84). To tackle the problem it is essential for Xiamen to coordinate the trade reform with other economic policy reforms. For example, the foreign exchange retention scheme should be gradually phased out or replaced by another form of incentive in order to reduce monetary expansion; fiscal reform can make tax rates on domestically produced final goods equal to tariff rates on their imports, thereby reducing protection, increasing revenue, and allowing tariff rates to be reduced further; reducing very high tariff rates may cause tariff evasion rates to fall and hence increase revenue; the use of a crawling peg and correction of the underlying fiscal imbalance can achieve a real depreciation; selective import liberalization can lower domestic prices by providing competition in the domestic market; and the scale and speed of infrastructure construction and real estate development can be reduced to easy pressure on the consumer goods market. Of course, these measures could not be introduced overnight, but should be phased-in over a period of two to three years and in right sequence.

However, they will not be effective in damping inflationary pressure if the price reform remains stagnant. This is because semi-reformed prices and the resulting relative prices continue to send out wrong signals to producers and traders. If the exchange rate is used to combat inflation in this situation, as occurred in a few Latin American countries (Corbo and de Melo, 1987; Kiguel and Liviatan, 1988), the effectiveness of those measures will be further reduced. The price reform in Xiamen has, as demonstrated in Chapter 7, been strongly influenced by the domestic price reform policy because of Xiamen's close and growing links with the domestic economy. Thus, as long as Xiamen is refrained from carrying out a radical price reform in the light of its own needs (*inter alia*, to co-ordinate the drastic changes in its foreign trade sector), the anti-inflationary measures will not be effective and a rapid trade expansion will inevitably result in a high rate of inflation.

8-4. Prospects of the Xiamen SEZ: the Three Important Relationships

The relationships between the Special Policy and the economic reform in Xiamen, between the SEZ and the domestic economy, and between the local economic development and the foreign economic forces are crucial because they not only, as we have seen, hold the key to the understanding of the policy problem in Xiamen and the effectiveness and significance of its experimental function, but also will play a decisive role in shaping Xiamen's future.

8-4-1. The Relationship between the Special Policy and the Economic Reform

The Special Policy is unique to China's SEZs. Clearly, it has been responsible for the rapid development of foreign economic activities, in particular the introduction of FDI,

which has become the engine of the growth of Xiamen's economy in recent years. Also, it has facilitated some instrumental experiments in the SEZ, such as the ways of organising capital construction and recruiting staff and workers, and the gradual introduction of foreign enterprise management ethics (including discipline in production, respect of deadlines, striving for quality, and spirit of innovation). These experiences are certainly conducive to China's industrial reform.

However, the foreign economic achievements in the SEZ were made primarily by opening up more and more areas or sectors, and by offering more and more financial concessions, to foreign (especially Taiwanese) investors. The so-called reform experiences are piecemeal and fragmentary and derived from less important fields of the reform. In the crucial areas, such as the reform of SOEs, the transformation of the local industry, and the management of the decentralized trade system and semi-reformed prices, Xiamen has hardly produced any significant and applicable experiences for the domestic reform.

Further, the Special Policy has also created some negative effects. The financial incentives offered to foreign investors have attracted the attention of the controllers of resource flows both in the SEZ and interior regions, and they have abused the terms for their own benefits. The distortions created by such incentives have sent out the wrong signals to producers and traders, leading to the severe internal price competitions, widespread corruptions and the loss of economic efficiency. It is in this sense that the implementation of the Special Policy has *obscured* and indeed, in some cases, *disrupted* the economic reform in the SEZ.

In short, the Xiamen authorities have failed to constructively make use of the power and privilege granted by the Special Policy to tackle the outstanding problems in the old economic system. They ought to realize that the Special Policy may *facilitate* but cannot *substitute* the real economic reform and that a package of financial incentives and

administrative simplifications does not add up to a market economy.

8-4-2. The Relationship between Xiamen and the Domestic Economy

Compared with EPZs, the close and extensive link with the domestic economy is a distinctive feature of the Xiamen SEZ. The experience to date has suggested that the link is more important to the development of the SEZ than its relationship with the outside world, despite the fact that the SEZ is designated to develop an outward-looking economy.

There are both political and economic reasons for the close tie. Politically, the Chinese central government, though encouraging all SEZs to develop a market-oriented economy, has always seen them as "an integral part of the national economy" and their development must therefore come under "direct control of the central or provincial government" (Chen and He, 1989: 10).[12] Clearly, China will never accept that SEZ economy may one day become independent of the national economy. That is why the SEZs have, from very beginning, been saddled with many tasks designed to serve the domestic economy, or to play many "inward functions" (*Neixiang Gongneng*).

The economic reason is that all SEZs need external assistance, especially at the early stage of development, to build or improve their infrastructures and industrial capacities. Domestic resources, which are both cheap and easy to get, obviously are their number one choice. For Xiamen, there is one more piratical reason. As an established industrial city within China's old central planning system, it had already developed all kinds of economic links with various sectors, regions and enterprises in the interior. Thus, it is hard for Xiamen to replace the old supply-demand network overnight, but has to continue relying on it to develop for the time being.

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[12]. For more accounts on this stance of the Chinese government, see Kleinberg (1990), Chapter 3, 4 and 10.

From a national perspective, the crucial question to ask is whether the transfer of resources from the interior to the SEZ represents a more efficient use of the resources and hence a net gain to the Chinese economy as a whole. Unfortunately, observers are now increasingly inclined to suggest or argue that it represents a net *loss* (e.g. Wall, 1992; Crane, 1992; Zhang Jun, 1993), although none of them has produced convincing evidences to support this view.

As far as the Xiamen SEZ is concerned, the close link with the interior economy has mixed effects on its development. On the one hand, the link has enabled Xiamen to get vitally needed interior physical, human and financial resources, which have greatly strengthened the local infrastructures and industrial capacities and thus enhanced Xiamen's ability to attract more and better-quality foreign investments.

On the other hand, as a result of the domestic tie, Xiamen has become very reliant on the domestic market and indeed more vulnerable to the domestic economic cycle than to the changes in the world market. During the 1980s, the Chinese economy underwent boom-bust cycle twice (in 1985 and 1988-89) and the Xiamen economy has also been hit hard (Chen and He, 1989: 10).[13] Further, many domestic-associated enterprises are also the result of distortions in the price, planning and factor supply systems. For example, a large number of them came to the SEZ to run commercial and trade businesses, instead of manufacturing ventures, as the SEZ would hope, in order to maximize the windfall gains created by the Special Policy.

More significantly, the domestic link has brought substantial amount of the old, less-reformed domestic economic elements into the SEZ through various forms of economic

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[13]. The effects of the austerity programmes on the development of the SEZs have worked mainly through credit tightening and the cutback of the supplies of key raw materials and energy, imposed by the central authorities uniformly throughout the country

associations, reinforcing the old economic system in the SEZ.[14] To deal with the growing domestic businesses, Xiamen had to maintain or restore some parts of the old planning and management structure, rather than reform or replace them, in order to be "compatible to the hierarchy of domestic authorities" (Huang Shanghe, 1988: 15). It is in this sense that the close domestic economic link has retarded the pace of the development of a new, outward-looking economy in the SEZ.

That is why the reform in Xiamen has been, as pointed out by many critics, "dominated by the domestic reform policy" (ibid; Guo Zheming, 1988: 45), rather than its own needs of developing an export-oriented market economy. That is why the reform policy in Xiamen has shown many symptoms observed in the domestic reform policy, notably, lack of co-ordination, inconsistency, ambiguity, and uncertainty. Thus, how to deal with the dilemma of weakening or severing the institutional link with the domestic economic system and policy while maintaining or developing the normal economic link with the domestic market will hold the balance on the success of Xiamen's new, open economy in the future.

8-4-3. The Relationship between Xiamen and Taiwan

The unique Taiwan link is an important asset for Xiamen and indeed the SEZ has so far benefitted greatly from it. Today, Taiwan capital, as the largest FDI source in the SEZ, is exerting a significant impact on its economic development and indeed enhancing its role as a regional growth pole in the southeastern China.

However, Xiamen should be under no illusion about the role of Taiwan capital in its economy. Indeed, the kind of economic cooperation and integration which is taking place between the Shenzhen SEZ and Hong Kong will not happen between Xiamen and Taiwan in the near future. The main reason is that the PRC-Hong Kong relationship is quite different from the

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[14]. For example, for the "window" purpose, interior workers and managers were regularly sent to the SEZ for training.

PRC-Taiwan one. The former has been largely decided by Hong Kong's impending return to the PRC's sovereignty. The fundamental economic interests for both sides to cooperate are far more important than any other considerations. Without doubt, after 1997 the integration process will only become faster and smoother.

The latter, on the other hand, is still plagued by the four-decade-old political rivalry. The persistent refusal by the PRC and Taiwan to meet each other's political demands has become the major obstacle to further economic cooperation, let alone integration, between the two sides. There is very little prospect, at least in the foreseeable future, of either of the two changing its stance. It is this political stalemate in the PRC-Taiwan relationship which has prevented the potential of the economic cooperation and integration between the two sides from being fully tapped, thus overshadowing the prospects of Xiamen's development in the future.

At the same time, Xiamen must realize that its advantage over other parts of China in terms of the Taiwan link will gradually diminish as the sophistication level and sectoral scope of TDI in the mainland increase. Clearly, Xiamen has little chance to participate in hi-tech cooperations with its limited and weak industrial and technological capacities. Already, a number of Taiwan investors, especially those from Taiwan's leading companies with high technology, have chosen more developed industrial cities, such as Shanghai, Tianjing, Shengyang, Beijing, Wuhan and Chongqing, to set up their large, technology/capital-intensive projects. Thus, it is important for Xiamen to formulate, on the basis of its own comparative advantages and the dynamics of the industrial restructuring in both China and the neighbouring countries /regions, a long-term policy of utilizing TDI. From now on, the inflow of TDI projects should be subject to a stringent scrutiny and then directed to serve its own industrial development priority or designated investment structure. Otherwise, Xiamen will face a danger of becoming a dumping ground for Taiwan's "sunset industries."

However, Xiamen's unique role as a springboard for Taiwan's operations in the mainland will not be weakened as long as the one-way cross-straits investment is still conducted on an *indirect* base. There can be no doubt that once direct communication, transportation and business links with Taiwan commence, Xiamen will probably become the logistical centre for a larger-scale Taiwan business operations in the vast hinterland of the PRC.

For the moment, Xiamen can play a pioneering role in facilitating the formation of a possible, partial economic integration between Taiwan and the southern Fujian, with the former focusing on R & D and design of products, manufacturing technologies, business management and international marketing while the latter on massive production, especially of labour-intensive, light industrial exports. In the long run, particularly after the PRC take over the control of Hong Kong in 1997, Xiamen has a great potential in developing entrepôt trade between Hong Kong and Taiwan due to its unique geographical location.

Thus, there can be doubt that Xiamen will continue to play a constructive role in promoting the economic cooperation and integration between the southeastern China, Taiwan and Hong Kong. The pressure to keep up with Taiwan and Hong Kong, particularly for their investments, may give the authorities in Xiamen and indeed all over Southeast China motives for carrying out more radical market reforms. This will undoubtedly pave the way for the eventual formation of the so-called "Greater China Economic Areas," pulling the Chinese economy into the mainstream of the Asia-Pacific economy.

APPENDIX A

The Decision of the Central Committee of the Communist Party of China on Reform of the Economic Structure

— approved by the Third Plenary Session of the Twelfth Central Committee of the Communist Party of China on October, 20, 1984

The Third Plenary Session of the 12th Central Committee of the Communist Party of China , having analysed the current economic and political situation in China and summed up the experience, both positive and negative, in socialist construction and particularly that of reform of the economic structure in the urban and rural areas over the past few years, holds the consensus view that, proceeding from the overall need to build socialism with Chinese characteristics by integrating the basic tenets of Marxism with actual conditions in China, we must go a step further with the policy of invigorating the domestic economy and opening to the outside world and accelerate the restructuring of the national economy as a whole, with the focus on the urban economy, so as to create a new better situation for our socialist modernization.

I. Reform Is a Pressing Necessity In the Current Developments in China

China has prepared and practised reform of its economic structure for several years. The Third Plenary session of the Party's 11th Central Committee, in deciding to shift the focus of the work of the whole Party to economic construction stressed the imperative need to reform the economic structure for China's socialist modernization. The Party made tremendous efforts after that session to set things to rights and readjust the national economy and carried out reform mainly in the rural areas. The 12th Congress, basing itself on the historic change consequent upon the rectification of the guiding ideology of the Party set the explicit task of reforming the economic structure systematically. It pointed out that this reform would provide an important guarantee for keeping to the socialist road

and achieving socialist modernization. In the past two years and particularly since the beginning of this year the Party Central Committee and the State Council have taken a number of policy decisions and issued major directives stimulating reform in various fields in depth and breadth.

Our economic restructuring scored great achievements first in the countryside. Agricultural production which worried us for so long has been enabled to develop vigorously in a very short time, displaying the great vitality of our socialist agriculture. This is due fundamentally to a bold break with "Left" ideas. We have changed the structure of China's rural economy that was incompatible with the development of the forces of production in agriculture and introduced across the countryside the system of contracted responsibility for production with remuneration linked to output, bringing into play the enormous initiative of the 800 million peasants for building socialism. The rural reform is going forward and the rural economy is moving towards specialization, large-scale commodity production and modernization. Therefore, there is an urgent need to unclog the channels of circulation between town and country, expand the market for the increasing amount of agriculture products, and satisfy the rising needs of the peasants for manufactured goods, science and technology as well as culture and education. Our successes in rural reform and the demands on the cities by the growing rural economy provide highly favourable conditions for restructuring China's entire national economy, focusing on the urban economy.

Such restructuring has been repeatedly explored and tested in recent years, and a number of important measures have been taken. This has yielded marked results and important experience, and economic life has been invigorated to an extend unknown for many years. Our urban reform is only in the initial stage, however, and defects in the urban economic structure that seriously hinder the expansion of the forces of production are yet to be eradicated. The economic effectiveness of our urban enterprises is still very low, the huge potential of our urban economy is far from being fully tapped and there is serious loss and waste in production, construction and circulation. Expediting reform is a prerequisite for the growth of the urban economy. The cities are economic, political, scientific, technological, cultural and educational centres where modern industry and members of the working class are concentrated and they play the leading role in socialist modernization. Firm, systematic reform is the only way that the cities will play their due leading role of invigorating the urban economy and enlivening the domestic economy as well as opening to the outside world and promoting a healthier and faster development of the national economy as a whole.

It should also be noted that emerging on a global scale is a new technological revolution which presents both new opportunities and new challenges to our economic growth. This means that our economic structure must become better able to utilize the latest scientific and technological achievements, promoting scientific and technological advancement and generating new forces of production. Reform, therefore, is all the more imperative.

Political unity and stability in China are ever more consolidated; major successes have been achieved in economic readjustment; the economy has been growing steadily; the major targets of the Sixth Five-Year Plan (1981-85) have been fulfilled ahead of schedule; and the country's financial situation has improved gradually. This has made all comrades in the Party and the people of all nationalities much more confident about socialist modernization. Their wish to speed up reform of the economic structure is much stronger. In particular, the sound all-round consolidation of Party organizations at the central and the provincial, autonomous regional and municipal levels, has set, or is setting, to rights the ideas guiding all fields of work in modernization and has given or is giving, the reform a clear orientation. Conditions are now ripe for all-round reform of the conomic structure. We both can and must raise and expound in a rather systematic way, a number of major issues related to the reform so as to achieve unity of thinking and enhance it among all comrades in the Party (particularly among leading Party cadres). We must make the reform more effective and give fuller play to the superiority of socialism. The Central Committee hopes and is confident that the Third Plenary Session of the 12th Central Committee will play a historic role in drawing up a blueprint for an all-round reform quickening its tempo and stimulating the restructuring of the entire national economy with the urban economy as the focus, just as the Third Plenary Session of the 11th Central Committee did in setting things to rights and raising the task of restructuring the economy and promoting rural reform.

II. Reform is Aimed of Establishing a Dynamic Socialist Economic Structure

The founding of the People's Republic of China and the establishment of the socialist system marked the end of the century-old history of our people's misery in a semi-feudal and semi-colonial society. The system of exploitation was abolished and the people of all nationalities became real masters of their country. The people of the whole country, led by the Chinese Communist Party, has established an independent and fairly comprehensive industrial as well as national economic system through arduous efforts and have scored tremendous successes inconceivable in the old China, thus laying the indispensable material foundation for building China into a powerful and prosperous modern socialist country with high level of democracy and civilization. The people of all our nationalities have come to realize through long historical experience that only socialism can save China.

The founders of Marxism predictd that by eliminating the exploitation of man by man, socialism would make possible a higher rate of labour productivity and a faster expansion of the forces of production. The profound changes that have taken place in the 35 years since the founding of the People's Republic are an initial demonstration of the superiority of the socialist system. But this superiority, it must be pointed out, has yet to be brought into full play. Apart from historical, political and ideological causes, a major economic cause for this is a rigid economic structure that cannot meet the needs of the growing forces of production. Following are the major defects of this structure: No clear distinction has been drawn between the functions of the government and those of the enterprise; barriers exist between different departments or regions; the state has exercised excessive and rigid control over enterprises; no adequate importance has been given to commodity production, the law of value and the regulatory role of the market; and there is absolute equalitarianism in distribution. This has resulted in enterprises lacking necessary decision making power and the practice of "eating from the same big pot" prevailing in the relations of the enterprises to the state and in those of the workers and staff members to their enterprises. The enthusiasm, initiative and creativeness of enterprises and workers and staff members have, as a result, been seriously dampened and the socialist economy is bereft of much of the vitality it should possess.

China gradually established a unified and centralized economic structure on a nationwide scale in the early post-liberation days and during the Five Five-Year Plan (1953-57) when the country faced the heavy tasks of unifying its financial and other economic work carrying out socialism transformation of capitalist industry and commerce and under taking large scale planned economic construction. However, control then was not very rigid in many aspects and the measures and steps we took for socialist transformation were based on China's actual conditions and were highly creative. But with the basic completion of socialist transformation and the ever-growing scale of economic construction, the measures taken to restrict and transform capitalist industry and commerce no longer suited the new situation. The defect of excessive and rigid control gradually become manifest in some aspects of the economic structure. The Central Committee and especially the comrades in overall charge of economic work, at the Eighth National Congress of the Party in 1956 as well as before and after perceived this problem and raised some suggestions for correction. However, our Party was after all, inexperienced in guiding socialist construction. Certain rigid concepts about socialism developed over the years that were not in keeping with the actual conditions in China. The influence of the "Left"-deviationist errors in the Party's guiding ideology after 1957 in particular, resulted in the various correct measures aimed at enlivening enterprises and developing socialist commodity economy being regarded as "capitalist". As a result of all these, the problem of overconcentration in the economic structure long remained unsolved and , what is more, became more and more serious. It is true that we tried to delegate power to lower levels on a number of occasions. But this was limited solely to readjusting the administrative power of the central and local authorities and of the different departments and regions. The critical issue of giving enterprise decision-making power was not dealt with. We therefore failed to break with outmoded conventions.

To bring about a radical change in the economic structure that hinders development of the forces of production, we must conscientiously sum up China's historical experience and study the concrete

conditions and requirements for economic growth. In addition, we must draw on the world's advanced methods of management, including those of developed capitalist countries that conform to the laws of modern socialized production. In line with the Party's consistent principle of integrating the fundamental tenets of Marxism with China's actual conditions and the principle of adopting a correct approach towards foreign experience the Central Committee holds that we must emancipate our minds more, follow our own road and build a socialist economic structure with Chinese characteristics that is full of vigour and vitality so as to promote the growth of the forces of production. This is the fundamental objective of our present reform.

The basic contradiction in socialist society remains that between the relations of production and the forces of production, between the superstructure and the economic base. Reform of China's economic structure means reforming, on the premise of adherence to the socialist system, a series of inter-related links and aspects of the relations of production and the superstructure that are not suited to the development of the forces of production. As a form of self-improvement and development of the socialist system, this reform is to be carried out under Party and government leadership in a planned, systematic and methodical way. It should serve to advance, and not to impair, social stability, expansion of production, improvement of the people's living standards and the growth of state revenue. The essential task of socialism is to develop the forces of production, create ever more social wealth and meet the people's growing material and cultural needs. Socialism does not mean pauperism, for it aims at the elimination of poverty. We must, with firm determination and maximum tenacity, concentrate on economic development and modernize China's industry, agriculture, national defence and science and technology. This is the inevitable trend of history and the wish of the people. In carrying out reform, all Party comrades must unfailingly grasp the above-mentioned basic concept of Marxism and set whether the reform facilitates this task as the most important criterion for assessing the success or failure of all reforms.

III. Invigorating Enterprises is The Key to Restructuring the National Economy

The chief and direct responsibility for industrial production and construction and commodity circulation falls on urban enterprises. They constitute the main force spurring the growth of the forces of production and encouraging economic and technological progress. China now has over one million urban industrial, building, transport, commercial and service enterprises, with a total work force of more than 80 million. The taxes and profits delivered by urban industrial enterprises alone account for over 80 per cent of the state's revenue. This means that the enthusiasm, initiative and creativity of the urban enterprises for production and operation as well as their 80 million workers and staff members must be brought into full play, in other words, the urban enterprises must have great vitality. This has a vital bearing on basic improvement of the national economy as a whole and of the state's financial and economic situation and on quadrupling China's annual industrial and agricultural output value by the end of the century, a task set by the Party's 12th National Congress. Socialism with Chinese characteristics should, first and foremost, be able to instil vitality into the enterprises. In essence, the drawbacks of our present economic structure are precisely the lack of vitality in our enterprises. Therefore, the key to restructuring the national economy, with the focus on the urban economy, is invigoration of enterprises, particularly the large and medium-sized enterprises owned by the whole people.

With this key in mind, we must handle two types of relationships satisfactorily. That means we should extend the decision-making power of enterprises owned by the whole people by establishing a correct relationship between them and the state, and safeguard the status of the workers and staff members as masters of the enterprises by establishing correct relationships between them and their enterprises.

One of the main reasons why the state exercised excessive and rigid control over enterprises in the past was to equate the concept of their ownership by the whole people with the concept of their direct operation by the state institutions. As Marxist theory and the practice of socialism have shown, ownership can be duly separated from the power of operation. To make the economic activities of

all enterprises conform to the overall requirement of economic growth, the socialist state institutions must manage, inspect, guide and regulate the activities of the enterprises, as is necessary, through planning and by economic adminsitrative and legal means; it must use taxation and other means to concentrate in its treasury that part of enterprises net income which should be used by the state in a unified way; it must designate, appoint and remove the principal leading members of the enterprises or approve their employment and election; and it must decide on the establishment of enterprises, their removal to other places, their switching over to other lines of products, their merger with others, suspension of operations, or closing down. However, since social demand is very complex and in a state of constant flux, since the conditions in enterprises differ in a thousand and one ways and since the economic links between enterprises are complicated, no state institution can know the whole situation fully and cope with everything in good time. If the state institutions were to directly administer and manage various kinds of enterprises owned by the whole people, it would be very hard to avoid serious subjectivism and bureaucratism with a consequent suppression of enterprise vitality. Therefore on the premise of following the state plans and subjecting itself to state control, the enterprise has the power to adopt flexible and diversified forms of operation; plan its production supply and marketing; keep and budget funds it is entitled to retain; appoint, remove, employ or elect its own pesonnel according to relevant regulations; decide on how to recruit and use its work force, and on wages and rewards; set the prices of its products within the limits prescribed by the state; and so on. In short, the enterprise should be truly made a relatively independent economic entity and should become a producer and operator of socialist commodity production that is independent and responsible for its own profit and loss and capable of transforming and developing itself and that acts as a legal person with certain rights and duties. This is the way to ensure both overall unity of the growth of the national economy as a whole and the diversity and flexibility of individual enterprises in production and management as well as their desire to make progress. Instead of weakening socialist ownership by the whole people, this will contribute to consolidating and improving it.

The well-spring of vitality of the enterprise lies in the initiative, wisdom and creativeness of its workers by hand and brain. When the status of the working people as masters of their own enterprise is guaranteed by its rules and regulations and when their labour is closely linked with their own material benefits, their initiative, wisdom and creativeness can be brought into full play. This has been vividly and convincingly proved by our experience in rural reform. In restructuring the urban economy, it is imperative to handle correctly the relationship of the workers and staff to their enterprise so that they are its real masters and can work as such at their jobs. This will arouse their deep interest in the operation and effectiveness of their enterprise, so that their performance is closely linked with their social prestige and material benefits. Modern enterprise calls for centralized and unified leadership and direction of production and strict labour discipline. Because ours are socialist modern enterprises, in carrying out such centralized leadership and strict discipline, we must resolutely ensure the workers and staff and their elected representatives the right to participate in democratic management of the enterprise. Under socialism, there is unity between the authority of the enterprise's leadership and the status of the working people as masters of the enterprise and their initiative and creativity. This unity is a prerequisite for the proper effective exercise of their initiative.

Correct relations between the state and the enterprise and between an enterprise and its workers and staff are the essence and basic requirement of the restructuring of the national economy as a whole with focus on the cities. Fulfilment of this basic requirement inevitably calls for reform of every aspect of the entire economic structure. This involves a whole range of reforms including planning, pricing, economic management by state institutions, and the labour and wage system. The Central Committee is of the opinion that these reforms should be carried out step by step in harmony with the inherent connections between the various links of the national economy, according to the degree of ripening of the subjective and objective conditions and in the right order of importance, urgency and feasibility, and that they should basically be accomplished in about five years. Specific plans will be drawn up separately to this end.

IV. Establish a Planning System Under Which the Law of Value Is Consciously Applied For Developing a Socialist Comodity Economy

Socialist society practises a planned economy on the basis of public ownership of the means of production. It can thus avoid the anarchy of production and cyclical crises characteristic of capitalist society and ensure that production constantly meets the growing material and cultural needs of the people. This is one of the fundamental indicators of the superiority of a socialist economy over a capitalist economy. Since the founding of the People's Republic, we have practised a planned economy and concentrated vast financial, material and human resources on large-scale socialist economic construction with tremendous achievements to our credit. At the same time, historical experience shows that the socialist planning system should be one that combines uniformity and flexibiligy. We must take into account China's vast territory and large population, the difficulty of drastically improving in a short period its poor transport conditions, its inadequate information facilities and the obviously uneven economic and cultural development of its various regions and we must realize that because of China's rather undeveloped commodity production at the present stage, it is necessary to stimulate commodity production and exchange. In view of all this, it is all the more urgent for us to institute this planning system. If the actual conditions of our country are ignored and if we try to incorporate all economic activities into the plans and implement them by administrative orders alone in disregard of the importance of the economic levers and the market, then there will unavoidably be a discrepancy between the subjective guidelines for planning and objective conditions, with the plans seriously out of step with reality. After the October Revolution, Lenin expressed the idea when working out Russia's plan for electrification that "a complete, integrated, real plan for us at present = 'a bureaucratic utopia'." "Don't chase it," he added. Although China's conditions today are vastly different from those of Russia at that time when its economy was in extreme difficulties, our practical experience has proved that this idea of Lenin's was not only applicable to the Russia of that day, it is also of lasting significance. We must be realistic and admit that for a considerably long time to come, our national economic plans on the whole can only be rough and elastic and that we can do no more than, by striking an overall balance in planning and through regulation by economic means, exercise effective control over major issues while allowing flexibility on minor ones. In this way, we will be able to ensure the appropriate proportions between the major economic branches and, in general, the proportionate and co-ordinated growth of the national economy.

In the reform of the planning system, it is necessary, first of all, to discard the traditional idea of pitting the planned economy against the commodity economy. We should clearly understand that the socialist planned economy is a planned commodity economy based on public ownership, in which the law of value must be consciously followed and applied. The full development of a commodity economy is an indispensable stage in the economic growth of society and a prerequisite for our economic modernization. It is the only way to invigorate our economy and prompt enterprise to raise their efficiency, carry out flexible operations and promptly adapt themselves to complex and changing social demands. This cannot be achieved by relying only on administrative means and mandatory plans. Meanwhile we must also realize that the extensive growth of a socialist commodity economy may also lead to certain disorder in production and there have to be guidance, regulation and administrative control through planning . This can be achieved under socialist conditions. Therefore a planned economy by no means excludes the application of the law of value and the growth of commodity economy; they in fact form a unity. It would be wrong to pose one against the other. The difference between socialist and capitalist economy as far as a commodity economy and the law of value are concerned, lies not in whether these are still functioning, but in the difference in ownership, in whether there is an exploiting class and whether the working people are masters of the state, in the different purposes of the production, in whether the law of value can be consciously applied throughout society and in the different scopes of commodity relations. Under our socialist conditions, neither labour power nor land, mines, banks, railways and all other state-owned enterprises and resources are commodities.

In the light of historical experience and the practice since the Third Plenary Session of the 11th Party Central Committee, the basic characteristics of our planning system can be further summed up

as follows: First, ours is on the whole a planned economy, that is, a planned commodity economy, not a market economy that is entirely subject to market regulation. Second, production and exchange completely subject to market regulation are confined mainly to certain farm and sideline products, small articles of daily use and labour services in the services and repair trades, all of which play a supplementary but indispensable role in the national economy. Third, our planned economy does not necessarily mean the predominance of mandatory planning, both mandatory and guidance planning being its specific forms. Fourth, guidance plans are fulfilled mainly by use of economic levers; mandatory plans have to be implemented, but even then the law of value must be observed. To reform our present planning system in accordance with the above points, it is necessary, step by step and to an appropriate extent, to reduce the scope of mandatory planning and extend guidance planning. Mandatory planning will be applied to major products which have a direct bearing on the national economy and the people's livelihood and which have to be allocated and distributed by the state, as well as major economic activities that affect the overall situation. Other products and economic activities which are far more numerous should either come under guidance planning or be left entirely to the operation of the market, as the case may require. The focus of planning will be shifted to medium and long-term planning, and annual plans will be appropriately simplified. There should be a corresponding reform of the methods of planning, full attention should be paid to economic information and forecasting so as to raise the scientific level of planning.

V. Establish a Rational Price System and Pay Full Attention To Economic Levers

Because the law of value was long neglected and because of various other historical reasons, there is much confusion in our present system of pricing. The prices of many commodities reflect neither their value nor the relation of supply to demand. This irrational price system has to be reformed. Otherwise it will be impossible to assess correctly the performance of enterprises, ensure the smooth circulation of goods between urban and rural areas, promote technological advances and rationalize the production mix and consumption patterns. This will result in an enormous waste of social labour and seriously hamper application of the principle of distribution according to work. As the decision-making power of enterprises grows, pricing will be increasingly important in regulating their production and operation. It is, therefore, all the more urgent to establish a rational system of pricing. The various aspects of the reform in economic structure, including planning and wage system, depend to a large extent on reform of the price system. Pricing is a most effective means of regulation, and rational prices constitute an important condition for ensuring a dynamic yet not chaotic economy. Therefore, reform of the price system is the key to reform of the entire economic structure.

Our present irrational price system finds expression mainly in the following: inadequate price differentials for a given product with diverse quality, irrational price ratios between different commodities, particularly the relatively low prices for some mineral products and raw and semi-finished materials and the retail price of major farm and sideline products being lower than their state purchasing price. From now on, we must gradually redress this irrational situation.

The irrational system of pricing is closely related to the irrational system of price control. In readjusting prices we must reform the over-centralized system of price control gradually reducing the scope of uniform prices set by the state and appropriately enlarging the scope of floating prices within certain limits and of free prices. Thus prices will respond rather quickly to changes in labour productivity and the relation between market supply and demand and better meet the needs of national economic development.

As the reform of the price system affects every household and the national economy as a whole, we must be extremely prudent, formulate a well-conceived, feasible programme based on the growth of production and the capability of state finances and on the premise that the people's real income will gradually be increased, and then carry it out in a planned and systematic way. The principles guiding the reform are: First, we should readjust irrational price ratios on the basis of the exchange of equal values and changes in the relation between supply and demand, lowering or raising prices

as the case may be. Second, when the prices of some mineral products and raw and semi-finished materials are raised, the processing enterprises must substàtially cut down consumption so that the increased production cost resulting from the higher prices of such products and mateials can be basically offset within the enterprises, with only a small part of the increase being borne by the state through tax reductions and exemptions. This will avoid a consequent rise in market sales prics of manufactured consumer goods. Third, in solving the problem of the state purchasing farm and sideline products at prices higher than their selling prices and in readjusting the prices of consumer goods, we must adopt effective measures to ensure that the real income of urban and rural inhabitants does not go down as a result of price readjustments. Instead, with the growth of production and improvement in economic results, the pay of workers and staff members will have to be raised gradually. It must be widely publicized among the people that on the condition of developed production and ever greater abundance of goods, the reform of the price system and readjustment of various irrational price ratios carried out on our own initiative will never bring about a general and spiralling price rise. Such a reform is the urgent need for further developing production and accords with the fundamental interests of the consumers. All enterprises should achieve better economic results through efforts to improve management and operation and should never try to increase their income by price increases. It is absolutely impermissible for any unit or person to boost prices at will by taking advantage of the reform, deliberately generating a tendency towards a general rise in prices disrupt the socialist market and harm the interests of the state and the consumers.

While reforming the price system, we should further improve the tax system and reform the financial and banking systems. The more the economy is enlivened, the more attention we should pay to macro-economic regulation and the more we should try to have timely grasp of economic trends so as to use pricing , taxation, credit and other economic levers better. This will help regulate such major proportional relations as those between aggregate social supply and aggregate social demand and between accumulation and consumption, regulate the direction of the flow of financial, material and human resources, regulate the industrial set-ups and the distribution of the forces of production, regulate market supply and demand, regulate external economic exchange and so on. We have fallen into the habit of using administrative means to keep the economy functioning and have long neglected the use of economic levers for regulation. Economic departments at various levels, especially the departments in charge of comprehensive economic management must take it as an important task to learn to use the economic levers and make this aspect the focus of our leadership over economic work.

VI. Separate Government From Enterprise Functions So That Government Organs Can Properly Perform Their Function of Managing the Economy

After the proletariat and the whole people take state power in their hands, it becomes a basic function of the state organs to lead and organize economic construction. Over the past 30 years or more since the founding of New China, our state organs have, on the whole, played a significant role in performing this function. But how the state organs, especially government departments can better lead and organize economic construction to meet the needs of the national economy and social development still remains a question calling for effective solution. The functions of government for a long time were not separated from those of enterprises which in fact became appendages of administrative organs and the central and local governments took responsibility for many matters which were not really theirs and at the same time did not do well what they ought to do. This plus the barriers between different departments or regions and the practice of endless wrangles increased the difficulties in running enterprises. If this state of affairs were not changed, the enthusiasm of the enterprises and other grass-roots units could not be aroused, co-operation, association and competition between enterprises could not develop and a unified socialist market would not grow. Moreover, the role that government organs should play in managing the economy would be seriously weakened. So there is a pressing need to conduct reform in line with the principle of separating the functions of government and enterprises, streamlining administration and instituting decentralization in order to invigorate the enterprises and the national economy as a whole.

Practical experience over the years shows the following to be the principal functions of government organs in managing the economy: They should formulate the strategy, plans, principles and policies for economic and social development, work out plans for the exploitation of natural resources, for technological transformation and for the development of intellectual resources; coordinate the development plans of localities, departments or enterprises and the economic relations among them; arrange for the construction of key projects, especially those in energy, transport and the raw and semi-finished materials industries; collect and disseminate economic information, learn to utilize economic means of regulation; work out economic regulations and ordinances and supervise their execution; appoint and remove cadres within a prescribed scope; administer matters related to external economic and technological exchanges and co-operation; etc. The performance of these functions requires immense efforts on the part of the governments at various levels. In the past some of the functions were not performed well and others not performed at all. As far as the relations between governments and enterprises are concerned, from now on government departments at various levels will, in principle, not manage or operate enterprises directly. As for the small number of government economic departments that have been entrusted by the state with direct operations and management of enterprise, they must also correctly handle their relations with the enterprises under them through simpler adminsitration and decentralization so as to enhance the capacity of enterprises and other grass-roots units for independent management and avoid drawbacks that may arise from over-centralization. The national and local corporations are economic associations set up for better economic development and mutual benefit of enterprises concerned. They must be enterprises and not administrative organs and must not follow old practices but should master modern methods of scientific management.

After the function of government and enterprises are separated, the central role of cities must be brought into full play and open and inter-connected economic zones of various size gradually formed with support from cities, the large and medium-sized cities in particular. In this reform it is necessary to call the attention of all leading urban comrades to the need for the city governments to separate their functions from those of enterprises and achieve simpler and decentralized adminsitration, and not to repeat the past practice of mainly depending on administrative means to control enterprises so as to avoid creating new barriers between departments or regions. City governments should concentrate on urban planning, construction and management; building public facilities; carrying out comprehensive ecological improvement; guiding and promoting the specialized co-operation of enterprises, their reorganization, association and technical transformation and the modernization of their management and operation; guiding and promoting a rational circulation of materials and commodities; improving cultural, educational, public health and social welfare work and various services; promoting the building of a civilization with a high cultural and ideological level, and the fostering of better social conduct; and maintaining public order. Moreover, they should also work out satisfactory medium and long-term plans for economic and social development based on the general requirements of developing the national economy and on local conditions.

The relationship between socialist enterprises is first of all one of co-operation and mutual support, but this by no means excludes competition.For a long time, people used to consider competition peculiar to capitalism. As a matter of fact, where there is commodity production, there is bound to be competition. The point is that the purpose, nature, scope and means of competition vary under different social systems. Competition between socialist enterprises is fundamentally different from that under capitalism where the law of the jungle prevails. On the basis of public ownership and subject to the control of state planning and laws, and for the purpose of serving socialist modernization, our enterprises are put to the test of direct judgement by consumers in the marketplace so that only the best survive. This will help to break the blockade and monopoly hampering the growth of production lay bare the defects of enterprise quickly and stimulate enterprises to improve technology, operation and management. It will stimulate the economy as a whole and benefit socialism. As for some undesirable trends and unlawful acts that may appear in the course of competition, the relevant leading organs at various levels should keep a clear head and strengthen education and control and tackle such problems in real earnest.

More and more norms guiding economic relations and activities will have to be framed in the form

of law in the restructuring of the economy and national economic development. State legislative bodies must produce economic legislation faster, the courts should make greater efforts to try economic cases, the procuratorates should strengthen their work in dealing with economic crimes, and the judicial departments should offer active legal services for economic construction.

The separation of the functions of government and enterprises as well as simpler and decentralized adminsitration constitute a deep-going transformation of the socialist superstructure. When the structure changes, the organization and the style of thinking and work should also change. We must unhesitatingly change the working style of government departments in accordance with the principles of serving the people and of streamlining, unification and efficiency and raise the competence of their functionaries. We must end the long-standing practice of leading organs making enterprises and units completely dependent on them, instead of serving the enterprises and other grassroots units, and eliminate such bureaucratic maladies as organizational overlapping, overstaffing, vague delimitation of functions and endless wrangling. The leading organs at various levels will thus be able to orient their work towards promoting production, serving the enterprises and other grassroots units and helping build a strong and prosperous country and bring prosperity and happiness to the people.

VII. Establish Various Forms of Economic Responsibility System and Conscientiously Implement the Principle of Distribution According to Work

Experimental urban reforms in the past few years have amply demonstrated that the basic experience of the system for contracted responsibility in the rural areas is also applicable in the cities. Enterprises must specify in explicit terms the requirements for each work post and the duties of each worker and staff member and must establish various forms of the economic responsibility system with contracted jobs as the main content so as to invigorate the urban enterprises, raise the sense of responsibility of the workers and staff members and bring into full play their initiative, enthusiasm and creativeness. The basic principles of this responsibility system are a combination of responsibility, authority and benefit; the unity of the interests of the state, the collectives and the individuals; and the linking of the income of workers and staff members with their job performance. In applying rural experiences to urban areas, we must take into account the characteristics of urban enterprises. It is neither feasible nor necessary to transplant mechanically the specific measures of the rural areas. As the nature of trades and the size and production conditions of enterprises differ from one another, urban enterprises cannot follow a single model of responsibility system. Our comrades, leading comrades of enterprises in particular, should always proceed from reality and in the course of practice gradually work out concrete forms of the responsibility system suited to their specific conditions. Then the contracted responsibility system will take root, blossom and bear fruit in the cities.

Modern enterprises have a minute division of larbour, a high degree of continuity in production, strict technological requirements and complex relations of co-operation. It is therefore necessary to establish a unified, authoritative and highly efficient system to direct production and conduct operations and management. This calls for a system of the director or manager assuming full responsibility. Party organizations in enterprises should actively support directors in exercising their authority in giving unified direction to production and operations, guarantee and supervise the implementation of the principles and policies of the Party, and the state, strengthen the Party's ideological and organizational work in enterprises, improve their leadership over the trade unions and Communist Youth League organizations and do effective ideological and political work among the workers and staff members. While the director assumes full responsibility, we must improve the system of congresses of workers and staff members and other systems of democratic management, give play to the authority and role of the trade union organizations and workers' and staff members' deputies in examining and discussing major decisions to be taken by the enterprises, supervising administrative leadership and safeguarding the legitimate rights and interests of the workers and staff members. All of this expresses the status of the working people as masters of the enterprise. Their status is determined by the nature of the socialist enterprise and must in no way be neglected or weakened.

With the general replacement of profit delivery by taxes and the widespread establishment of various forms of economic responsibility in enterprises, the socialist principle of distribution according to work will be implemented more fully. An important step already taken in this respect is that enterprises decide on the amount of bonuses for their workers and staff members according to the results of enterprise operation, while the state only collect an appropriate amount of tax on the above-norm bonus from enterprises. In the future, adequate measures will be taken to better link wages and bonuses with the improved enterprise performance. In the enterprise, the difference between the wages of various trades and jobs should be widened, so as to apply fully the principle of rewarding the diligent and good and punishing the lazy and bad and of giving more pay for more work and less pay for less work as well as to fully reflect the difference between mental and manual, complex and simple, skilled and unskilled, and heavy and light work. In particular, it is necessary to change the present remuneration for mental work which is relatively low. We should also reform the wage system in state institutions and public organizations in accordance with the principle of linking wages with responsibilities and achievements. While reform of the wage system in enterprises, state institutions and public organizations is under way, the reform of the labour system will be speeded up.

There has long been a misunderstanding about the distribution of consumer goods under socialism, as if it meant equalitarianism. If some members of society got higher wages throught their labour resulting in wide gaps in income, it was considered polarization and a deviation from socialism. This equalitarian thinking is utterly incompatible with scientific Marxist views on socialism. History has shown that equalitarian thinking is a serious obstacle to implementing the principle of distribution according to work and that if it is unchecked, the forces of production will inevitably be undermined. Naturally, a socialist society must guarantee its members a gradual improvement in material and cultural life and their common prosperity. But common prosperity cannot and will never mean absolute equalitarianism or that all members of society become better off simultaneously at the same speed. If common prosperity were understood as absolute equalitarianism and simultaneous prosperity not only would this be impossible, but such thinking would lead to common poverty. Only when some regions, enterprises and individuals are allowed and encouraged to get better off first through diligent work can there be a strong attraction and inspiration to the majority of the people. More and more people will be prompted to take the road of prosperity, one group after another. At the same time, we must provide social relief for the old, weak, sick, disabled and for widows, widowers, orphans and childless elders who cannot support themselves. We must aid those who have not yet become well-off and adopt special and preferential policies towards some old revolutionary base areas and minority nationality, remote and other areas where the economy is still very backward and give them the necessary material and technical assistance. The difference arising from the prosprity of some people before others is a differencce in speed, with all members of society advancing on the road to common prosperity. It is certainly not polarization, which means that a handful of people become exploiters while the vast majority fall into poverty. The policy of encouraging some people to get better off earlier accords with the law of socialist development and is the only road to prosperity for the whole of society.

We must never discard the fine tradition of working hard and building the country through diligence and thrift that was developed during the long period of our revolution and construction. In the new historical period this tradition chiefly means the spirit of working hard and defying all difficulties in dedication to the motherland and the people, practice of strict economy in production and construction, opposition to any act that squanders state materials and funds, and avoidance of erroneous policy decisions that result in waste. It should not be misconstrued as overlooking due growth in the people's level of consumption. According to the basic tenets of Marxism, production is the starting point and the predominant factor of all economic activities and determines consumption; but consumption also determines production in that the growth of consumption gives a strong impetus to creation of new social demands, opens up vast markets and encourages production. We must gradually bring about substantial increases in the pay of workers and staff members and in the people's level of consumption. This should be based on increased production, better economic results, a steady increase in state revenue and a correct proportion of accumulation and consumption. It is incorrect to put forward demands for consumption in excess of the capacity of current pro-

duction. But it is likewise incorrect not to appropriately increase but keep restricting consumption that is well within the capacity of current production.

VIII. Work to Develop Diverse Economic Forms and Continue to Expand Foreign And Domestic Economic and Technological Exchanges

We must mobilize all positive factors if we are to achieve rapid growth in all fields of production and construction and make our country strong and prosperous and our people rich and happy at a fairly fast pace. Under the guidance of state policies and planning, the initiative of the state, the collective and the individual should all be encouraged. We must work to develop diversified economic forms and various methods of management. And we must actively expand foreign economic co-operation and technological exchange on the basis of independence, self-reliance, equality and mutual benefit and mutual good faith.

Enterprises owned by the whole people constitute the leading force in China's socialist economy and are decisive in ensuring our socialist orientation and the steady growth of our entire national economy. But their consolidation and development should not be predicated on restriction and exclusion of other economic forms and other methods of management. The collective economy is an important component of the socialist economy and we can give the collectives a free hand in running enterprises in many area of production and construction. The individual economy now found in China is linked with socialist public ownership and differs from the individual economy linked with capitalist private ownership. It plays an irreplaceable role in expanding production meeting the people's daily needs and providing employment. It is a necessary and valuable adjunct to the socialist economy and is subordinate to it. At present, we should try to remove obstacles in the way of the collective economy and individual eocnomy in cities and rural towns and create conditions for their development and give them the protection of the law. We should promote individual economy particularly in those economic fields mainly based on labour services and where decentralized operation is suitable. Meanwhile we should on the basis of voluntary participation and mutual benefit extensively encourage diverse and flexible forms of co-operative management and economic association among the state, collectives and individual sectors of the economy. Some small state-owned enterprises can be leased to collectives or individuals, or run by them on a contract basis. It is our long term policy and the need of socialist development to promote diversified economic forms and various methods of operation simultaneously. This is not retrogression to the new-democratic economy of the early period of the People's Republic when the socialist public ownership was not yet predominant in town and country. Far from undermining China's socialist economic system, the new policy will help consolidate and develop it.

Marx and Engels pointed out long ago in the Manifesto of the Communist Party that with the exploitation of the world market due to the growth of capitalism, the old local and national seclusion and self-sufficiency had given place to intercourse between nations in every direction, and production and consumption in every country had become cosmopolitan in character. The productive forces including science and technology in our times are developing ever faster. Although international relations are complex and ridden with contradictions international economic and technological ties are, generally speaking, very close, and national seclusion cannot lead to modernization. Since the Third Plenary Session of the 11th Central Committee, we have taken opening to the outside world to be our long-term basic state policy, a strategic measure for accelerating socialist modernization. Practice has already yielded marked results. We must continue to pursue flexible policies, reform our foreign trade structure in line with the principle of both arousing the enthusiasm of all quarters and developing a unified approach in our external dealings. We will work to expand economic and technological exchanges and co-operation with other countries, strive for the success of the special economic zones and open more coastal cities. Using foreign funds and attracting foreign businessmen for joint ventures, co-operative management or exclusive investment in enterprises are also a necessary and beneficial complement to China's socialist economy. We must make the best use of both domestic and foreign resources and both the domestic and foreign markets, and learn both to organize domestic construction and develop foreign economic relations.

As we open to the outside world, we shall open up even more between different areas within China itself. We should smash blockades and open doors in the relations between economically more developed and less developed areas, coastal areas and interior and border areas, cities and countryside, and between all trades and enterprises. We must act in conformity with the principle of making the best possible use of favourable cvonditions and avoiding the effects of unfavourable ones, developing diversity of forms, offering mutual benefit and achieving common progress, and strive to develop economic relations among enterprises and regions, promote appropriate exchanges of funds, equipment, technology and qualified personnel, introduce diverse forms of economic and technological co-operation and run joint economic enterprises. This will speed up the rationalization of our economic setup and of the geographical distribution of our enterprises and accelerate modernization.

IX. Promote a New Generation of Cadres and Create a Mighty Contingent of Managerial Personnel for the Socialist Economy

Reform of our economic structure and the development of our national economy badly need a large contingent of managerial and administrative personnel, and especially managers, who are both knowledgeable in modern economics and technology and imbued with a creative, innovative spirit and who are capable of bringing about a new situation in whatever they do. The point now is that our contingent of managerial personnel falls far short of the above requirements. We have large numbers of veteran comrades in this contingent who, in the long period of hard struggle, have made great contribution to our socialist economic construction. Their good work style, managerial ability and steadfastness in observing the rules of inner-Party life had an educational influence on many young and middle-aged cadres. But they are getting up in years, and we can no longer ask them to continue in arduous leading posts. Our present urgent task is to promote boldly thousands upon thousands of young and middle-aged managerial personnel and take steps to train them.

Large numbers of talented persons have come to the fore in economic construction, especially in the course of Party consolidation and the reform of the economic structure. Party committees at all levels must take pains to discover and assess them and must not be fettered by outdate ideas and convention. They must not fault-find and demand perfection and must guard against the influence of factionalism and gossip. When we act in this manner, we can discover large numbers of excellent cadres. Of course, young and middle-aged cadres lack experience in giving leadership. But they can gain experience through tempering in practical work and will gradually do so. Under no circumstances should we use lack of experience as an excuse for holding back young cadres. We have to be analytical in our attitude to experience. Our comrades accumulated rich experience, both positive and negative, in the course of revolution and construction. This is very valuable. Generally speaking, however, all our cadres, old, middle-aged or young, are facing brand-new tasks in the new historical period and all lack the new knowledge and experience necessary for modernization. All of them will have to re-evaluate their capabilities and make new efforts to learn. It would be wrong to hang on to the outmoded and rest complacent about experience that is no longer applicable.

The Central Committee calls for completion of the reshuffling of leadership in enterprises, especially key enterprises, before the end of 1985. In addition, plans should be drawn up and effective measures taken to train fairly soon large numbers of directors (managers) who can successfully organize and direct enterprise production and operations of chief engineers who can strengthen technical management and promote technological progress, of chief economic managers who can improve business operations for better economic results, of chief accountants who can strictly uphold financial and economic discipline, do careful budgeting and exploit new sources of revenue, and of Party secretaries who can keep to a correct political orientation and unite the workers and staff members of the enterprises. This is how to create a mighty contingent of managerial and technical cadres for the socialist economy. This contingent should consist of qualified personnel in all trades and occupations of the whole chain of enterprise management.

The Central Committee has pointed out on many occasions that in our drive for socialist modernization we must respect knowledge and talented people. We must combat all idea and practices that belittle science and technology, the cultivation of intellectual resources and the role of intellectuals. We must take resolute action to redress cases of discrimination against intellectuals which still exist in many localities and to raise the social standing of intellectuals and improve the working and living conditions. All our reforms must lead to progress in science and technology, to greater intiative of the localities, departments, units and individuals in making effective use of intellectual resources and must enable our vast numbers of young people as well as workers, peasants and intellectuals to raise their cultural and technical levels quickly. Those who have made important inventions and innovations or other outstanding contribution should be ample rewarded.

Science, technology and education are extremely important in developing our national economy. Advances in reforming the economic structure pose as a matter of increasingly urgent strategic importance the reform of our scientific, technical and educational setups. The Central Committee will hold special discussions on these issues and take relevant decisions.

X. Strengthen Party Leadership To Ensure the Success of Reforms

Reform of China's economic structure will be carried out over the fairly broad area and in a fairly deep-going way. It will have a direct bearing on the nation's future and affect the vital interests of millons upon millions of workers, peasants and intellectuals. All Party comrades should stand in the forefront of the reform, which represents the trend of our times. This reform is an exploratory and innovative undertaking by the masses and it is very complex. We are generally now at the stage of accumulating experience in the reform of the entire economic structure which focuses on cities, and the vast number of cadres are not familiar with this work. Leading Party and government functionaries at all levels have to be sober-minded and give meticulous guidance. They should emancipate their minds, seek truth from facts and proceed from reality and carry out Party policies creatively by integrating them with the actual situation in each locality, department and unit. Full consideration should be given to the particularities of the regions concerned in reforming the economic structure in minority nationality regions. All moves in the reform have to be tested in practice, through which new experience will be acquired. Errors can hardly be avoided, but we should make every effort to prevent them whenever possible. Once an error does occur, we must try to discover it promptly, resolutely correct it, draw the lessons and continue to go ahead. We should take active but prudent steps in carrying out reforms. We should carry them out firmly where we are sure of success, make reforms one by one when the conditions are ripe, and make experiments when we are not sure of success. We must not try to accomplish the whole task at one stroke. All major reforms which effect the whole country will be arranged by the State Council under a unified plan. All localities, departments and units should be encouraged to conduct exploratory and pilot reforms. Nevertheless, any reform involving the overall situation or one that is extensive in scope must first be approved by the State Council.

Party organizations in numberous localities and enterprises will undergo consolidation next year. Reform should be closely linked with this. Party consolidation should promote economic growth, which is an indicator of how successful it is. While carrying out the reform, we must strengthen the leadership over Party consolidation, making sure that the consolidation will not become a mere formality. The more we enliven the economy and invigorate enterprises, the more we must pay attention to combating the corrosive influence of capitalist ideas, eliminating the decadent practice of seeking personal gain by abusing one's position and authority and preventing any action that seriously harms the interests of the state and the consumers, and the more we should strengthen the building of a fine Party style and sense of discipline and maintain healthy inner-Party political life. In ideological and organizational work in the new historical period, we must firmly carry out the Party's guiding principle that such work should help fulfil the general task and reach the general goal set by the Party and be closely linked with economic construction and reform of the economic structure. We should actively support cadres and the masses who are keen on reforms. When errors or devia-

tions appear in the course of reform, apart from those seriously violating the law and discipline which must be dealt with according to law, we should adopt a policy of persuasion, criticism and education towards the persons concerned and must not stick political labels on them. People with different views and approaches about reforms may discuss their differences. We must not divide the cadres and masses by calling some people "reformers" and other "conservatives." We should have faith in comrades who fall behind the developing situation for a time, confident that they will understand things better in the course of reform. In the past five years of rural reform, many comrades who had doubts about it have been convinced by the facts and have changed their views. The Central Committee has adhered to the principle of patient education in guiding rural reform, thereby ensuring its smooth progress. This is a valuable experience in solving ideological problems inside the Party on the question of major policies and we should keep to this principle in the future. By citing the facts about reform, we should provide Party members and the masses with lively education in the theory and policies of the reform. This will help them realize that socialism with Chinese characteristics should be full of vitality, different from the rigid pattern of the past and fundamentally different from the capitalist system. This will deepen their understanding of scientific socialism so that they devote themselves to making reforms.

The reform of economic structure will lead to tremendous changes not only in people's economic life, but also in their mental outlook and way of life. We should build socialist civilization with both a high material level and high cultural and ideologcial level. This is our Party's unswerving principle. While trying to create a socialist economic structure full of vigour, we should work to create a cultured healthy and scientific way of life for the whole society that meets the requirements of expanding the modern forces of production and social progress, and eliminate backward and decadent ideas and ignorance. We should foster throughout society an active, forward-looking and enterprising attitude and overcome such forces of habit as complacency, mental sluggishness, fear of change and conventionality. Such an approach of life and such an attitude are important aspects of a socialist civilization that has a high cultural and ideological level. They give great impetus to reform of the economic structure and the building of a socialist civilization with a high material level. Comrade Mao Zedong said, "Mankind makes constant progress and nature undergoes constant change; they never remain at the same level. Therefore, man has constantly to sum up experience and go on discovering, inventing, creating and advancing. Ideas of stagnation, pessimism, inertia and complacency are all wrong. They are wrong because they agree neither with the historical facts of social development nor with the historical facts of nature so far known to us." This statement is a graphic expression of one of the fundamental points of view of the Marxist world outlook and conception of history. The Chinese Communists take the constant promotion of social development and progress as their historical mission. Our Party led the masses of the people under reactionary rule in the past in making revolution to overthrow the old order. Under the socialist system with the people as masters of the country, our Party has been leading the masses in consientiously carrying out reforms and building China into a modern, powerful socialist country with a high level of culture and democracy.

The current situation is very favourable to reform. The people are highly creative in this endeavour. By relying on their wisdom and strength and adhering to the four cardinal principles, we will certainly succeed in our reform and fulfil the general task and reach the general goal set by the Party's 12th National Congress.

As published in the ACFERT Editorial Board (1985), pp. 373-87.

APPENDIX B

Notice by the State Council on the Approval of the Report from the Ministry of Foreign Economic Relations and Trade on Reform of the Foreign Trade System

September 15, 1984

The State Council has approved the Report on Reform of the Foreign Trade System submitted by the Ministry of Foreign Economic Relations and Trade (hereinafter referred to as MFERT), which is hereby published for a conscientious study and implementation.

With a view to developing foreign trade in a better way, catering the needs of the socialist modernization drive, the reform on foreign trade system must be carried out. The current reform of foreign trade system is an important reform in our national economic structure. It is of great significance in implementing the policy of opening to the outside world and revitalizing domestic economy, further developing our foreign trade and accelerating the Four Modernization programs.

The reform of foreign trade system will involve a wide-ranging area in fundamental policy decision, and it is an arduous task. It is hoped that the cadres at all levels in the field of foreign trade, in localities and in other departments concerned should unify their thinking to understand the significance of these reforms, do away with out-dated conventions and the unwanted forces of habit. They must emancipate their minds, be boldly creative and carry out these reforms vigorously. They should do a sound job in earnest and implement the current reforms step by step in a planned way. In practice, they should study the new situation and solve the emerging problems in their work without delay. MOFERT should pay attention to and keep informed of the situation in the course of reforms from which the arising problems will be studied and settled promptly, so as to ensure that the foreign trade business will be conducted normally.

After the foreign trade system is reformed, MFERT must exercise overall leadership and centralized management of specialized departments over the national foreign economic relations and trade, assume fully the state function of administrating the foreign trade, and promote the development of foreign economic relations and trade by both arousing the enthusiasm of all quarters and developing a unified approach in our external dealings and with effective use of administrative and economic means.

All localities and the relevant departments should keep the overall situation in mind, strengthen leadership, make a concerted effort and act in close cooperation, so as to guarantee that the current reforms will be carried on successfully. We are convinced that, with joint efforts, the reform of foreign trade system will certainly achieve success, and a new situation in our national foreign trade will surely emerge, which will make new contributions to accelerating our national economic development.

MFERT's Report on Reform of the Foreign Trade System (Extracts)

August 14, 1984

In order to implement the policy of opening to the outside world and invigorating the domestic economy, bring into full play the initiatives of all quarters, continue to develop our national foreign trade and accelerate socialist modernization, we must carry out reforms on foreign trade system.

The basic principles set out by the State Council guiding these reforms are:

(1) To separate government functions from enterprise management so that MFERT holds the administrative control only;

(2) To introduce an agency system for foreign trade;

(3) to integrate foreign trade with increased production and the introduction of new technology, and imports with exports.

According to these principles and on the basis of investigation and serious discussions with relevant departments, we hereby put forward the following suggestions for the reform.

1. Separate Government Functions from Enterprise Management and Strengthen Administrative Management of Foreign Trade

After the government functions are separated from the enterprise management, MFERT and Foreign Economic Relations and Trade Departments (Commissions) of the provinces, autonomous regions and municipalities will hold administrative control only for foreign trade. The foreign trade enterprises will conduct independently the import-export business, keeping their own accounts and assuming responsibility for their own profits and losses. The administrative departments at all levels should not interfere with the specific business handled by the foreign trade enterprises.

To safeguard our national interests, we must exercise an unified leadership and centralized management of specialized departments in our foreign trade. We should fully arouse the enthusiasm of all quarters and adhere to the principle of an unified approach in our external dealings. MFERT should lead and administer the national foreign trade work plus various foreign trade enterprises by administrative and economic means. It's main tasks are as follows:

(1) To formulate foreign trade principles, policies, rules and regulations, organize their enforcement and supervise their execution.

(2) To draw up and assign the long-term plans for national foreign trade development and annual import-export commodity plans in coordination with the State Planning Commission, supervise and monitor their implementation, and hold responsibility for statistics.

(3) To work out economic measures for regulating import and export trade by using various economic means, supervise and monitor the operations of the foreign trade.

(4) To draw up foreign trade plans covering specific countries and regions, organize trade negotiations between governments, sign trade agreements and organize their implementations, represent the government to attend international economic and trade conferences.

(5) To examine and approve the establishment, merger and liquidation of the foreign economic and trade enterprises both at home and abroad, examine and approve the establishment of representative offices in China by foreign enterprises and administer their operations, and to administer our country's economic and commercial offices abroad.

(6) To examine, approve and issue import-Export licences take charge of end allocate quotas and quantitative limits, make and readjust the catalogues of import-export commodities which are under the unified management, examine and approve the import-export contracts relate to key technology items according to the state relevant rules and regulations.

(7) To keep the export trade marks under unified management.

(8) To take charge of the international market investigation and study, information exchange, provide prompt information and forecasting for the economic and trade enterprises and relevant departments all over the country.

(9) To report to the next higher economic and trade departments for the record of appointment and removal of members of board of directors, managers and deputy managers in various foreign

trade corporations throughout the country. The next higher economic and trade departments should supervise their business activities and put forward proposals to remove those who are not competent.

(10) To take the responsibility of excercising leadership over the higher learning institutes and schools of foreign economic relations and trade all over the country, organize staff training in the field of foreign economic relations and trade, and help the localities run well the schools of foreign economic relations and trade.

In accordance with the principle of administration at different levels, we call for the economic and trade departments of the provinces, autonomous regions and municipalities, as authorized by MFERT, to do a good job, within the above-mentioned ten functions, in administrating and supervising the various foreign trade enterprises in localities.

2. Simplify Administration and Transfer Power to Lower Administrative Levels and Bring into Full Play the Managing Initiative of Various Foreign Trade Enterprises

Simplification of administration and decentralization is the key to restructuring the foreign trade system. The specialized foreign trade corporations under MFERT and the foreign trade companies of other departments and localities should gradually become independent from their original administrative departments to which they were formly subordinated and perform management functions independently whilst keeping their own accounts, assuming responsibility for their own profits and losses, and developing in the direction of specialization and socialization.

To ensure the growth of foreign trade, we must continue to manage well the existing head offices of the national foreign trade corporations which are specialized and socialized. They are the mainstay of our national foreign trade. We should help them develop further. However, these big corporations will not be able to monopolize the entire foreign trade. There must be a large number of small and medium sized companies and enterprises to participate in foreign trade. They and the specialized foreign trade corporations will complement and promote each other's work, so as to activate foreign trade. When the conditions are ripe, we can set up a number of specialized companies according to needs. Some qualified big production enterprises may handle foreign trade business subject to approval.

To carry out the integration of foreign trade with production and technology remains an important policy for developing foreign trade and accelerating technological progress of our country. In line with their specific commodities, the foreign trade enterprises should actively develop diverse forms of such combinations with production enterprises and scientific and technical units, thus providing positive and good services in a better way for the enterprises' technical up-grading and introduction of advanced technology in our country. We should promote energetically the export of industrial manufactured goods, further improve the structure of our export commodities. The administrative departments at all levels should actively encourage and support the combination of foreign trade enterprises with production units.

The various foreign trade enterprises should do as follows:

(1) To implement conscientiously the state's principles, policies, rules and regulations on foreign trade, and accept MFERT's unified administration and supervision and undertake the assignments set by the state for export earnings and other import-export plans, and establish the economic responsibility system so as to integrate responsibility, management power and economic interests.

(2) The enterprises which apply for the power of managing foreign trade must submit their applications to MFERT for approval before their registration with the administrative departments of industry and commerce. They are to operate independently and assume full responsibility for their own profits and losses within approved business scope, and develop actively diverse forms of integrating foreign trade with increased production and new technology and adopt various forms of associations.

(3) All foreign trade enterprises should institute a management system under which the manager

either assume sole responsibility or report to a board of directors.

(4) According to the relevant policies and regulations set by the state, the foreign trade enterprises will manage their own internal affairs such as the organizational set-up, cadres allocation, staff management, wages, bonus, etc..

(5) The head offices of specialized foreign trade corporations will assume leadership over their branches, covering their plans and business etc.. The branches keep their own accounts, and undertake responsibility for their own profits and losses. The local foreign trade companies can form combinations with specialized corporations on a voluntary basis, or establish relations, partnerships, co-management or associations with them. However, they should not be regarded as branches of the specialized corporations.

3. Adopt Import and Export Agency System and Improve Operations and Management of Foreign Trade

By import and export agency system, we mean that foreign trade enterprises should provide diversified services, handle import and export business as entrusted by production units and order-placing departments and collect service charges, while profits and losses are to be born by the entrusting units. The fulfilment of the state foreign trade plan is jointly undertaken by foreign trade corporations and production enterprises. The import and export agency system will facilitate the direct combination of foreign trade enterprises with production units, and accelerate the integration of foreign trade with production and technology, improve the operation and management and raise economic efficiency. Therefore, the import and export agency system should be popularized gradually as the basic form of foreign trade.

(1) An agency system for all import business will be practised in principle, while the end-users take the responsibility for their own profits and losses.

The adoption of import agency system can facilitate economic accounts, encourage the end-users to use domestic products, help save foreign exchange and protect domestic production.

We should strive for success of the integration of foreign trade with production unit and technology, and import with export. While importing commodities, complete sets of equipment and advanced technology, the foreign trade corporations should earnestly consult the end-users, production units and the departments for material allocation and etc., invite them to join in technical and commercial negotiations and sign contracts according to their needs.

(2) An agency system for export business will be practised basically, but they will be defined separately as conditions vary with different commodities.

For the export of industrial and mineral products, we can basically practise agency system. In this case, production units will hold the responsibility for their own profits and losses; we can also adopt other forms such as entrusted processing, co-management, joint venture etc. Under such forms, the production units and foreign trade enterprises share their profits and losses. For the export of agricultural and side-line products and some handicrafts, the foreign trade corporations can still use the methods of direct purchase, entrusted purchased or jointly running the production bases. They can also practise an agency system if conditions permit. No matter what forms of management are to be taken, both sides should sign economic contracts, with a clear definition of economic responsibility and interest which the foreign trade enterprises and production units should take and share respectively. The foreign trade enterprises should provide the production units with good service and guidance, effect earnestly the linking of production with sales, so as to arouse the enthusiasm of production units, pay more attention to raising economic efficiency of export commodities, and continue to develop in the direction of more channels and less precedures. We should strive to develop the processing with imported materials in coastal cities, so as to promote a more vigorious development of foreign trade.

The import and export agency system should not be applied indiscriminately and foreign trade

corporations should be allowed to use more trading forms such as sole-operation, barter trade, cooperation and association, etc., to activate their operation.

4. Reform the Foreign Trade Planning System and Simplify Its Contents

The reform of foreign trade planning system is aimed at transferring more decision-making power of management to the foreign trade enterprises and production units under the state unified plan, enabling the foreign trade enterprises to be more flexible in their operation and more responsible to the changable international market, improving their management skills, and fulfilling the state plan with the maximum economic returns.

5. Reform the Foreign Trade Financial System and Strengthen the Economic Means of Regulation

The gradual introduction of import and export agency system will create favourable conditions to solve the problems of the existing foreign trade financial system under which "everyone eats from the same big pot" whilst the state bears the responsibility for all profits and losses. The various foreign trade enterprises should start paying tax instead turning over profits to the state. They should operate independently and undertake the duty for their own profits and losses. In line with the state relevant rules and regulations, they must pay taxes to the departments of finance and taxation. It is necessary to work out appropriate policies and measures to strengthen the economic means of regulation, establish economic responsibility system and guide the foreign trade enterprises to manage well according to the state needs.

If the above report is acceptable, please approve and inform the various departments and localities to implement it.

As published in the ACFERT Editorial Board (1985), pp 388-92.

APPENDIX C

The Law of the People's Republic of China on Joint Ventures Using Chinese and Foreign Investment

Adopted on July 1, 1979 at the Second Session of the Fifth National People's Congress; Promulgated on July 8, 1979

Article 1 With a view to expanding international economic cooperation and technological exchange, the People's Republic of China permits foreign companies, enterprises, other economic entities or individuals (hereinafter referred to as foreign participants) to incorporate themselves, within the territory of the People's Republic of China, into joint ventures with Chinese companies, enterprises or other economic entities (hereinafter referred to as Chinese participants) on the principle of equality and mutual benefit and subject to authorization by the Chinese Government.

Article 2 The Chinese Government protects, by the legislation in force, the resources invested by a foreign participant in a joint venture and the profits due him pursuant to the agreements, contracts and articles of association authorized by the Chinese Government as well as his other lawful rights and interests.

All the activities of a joint venture shall be governed by the laws, decrees and pertinent rules and regulations of the People's Republic of China.

Article 3 A joint venture shall apply to the Foreign Investment Commission of the People's Republic of China for authorization of the agreements and contracts concluded between the parties to the venture and the articles of association of the venture formulated by them, and the commission shall authorize or reject these documents within three months. When authorized, the joint venture shall register with the General Administration for Industry and Commerce of the People's Republic of China and start operations under license.

Article 4 A joint venture shall take the form of a limited liability company.

In the registered capital of a joint venture, the proportion of the investment contributed by the foreign participant(s) shall in general not be less than 25 per cent.

The profits, risks and losses of a joint venture shall be shared by the parties to the venture in proportion to their contributions to the registered capital.

The transfer of one party's share in the registered capital shall be effected only with the consent of the other parties to the venture.

Article 5 Each party to a joint venture may contribute cash, capital goods, industrial property rights, etc., as its investment in the venture.

The technology or equipment contributed by any foreign participant as investment shall be truly advanced and appropriate to China's needs. In cases of losses caused by deception through the international provision of outdated equipment or technology, compensation shall be paid for the losses.

The investment contributed by a Chinese participant may include the right to the use of a site provided for the joint venture during the period of its operation. In case such a contribution does not constitute a part of the investment from the Chinese participant, the joint venture shall pay the Chinese Government for its use.

The various contributions referred to in the present article shall be specified in the contracts concerning the joint venture or in its articles of association, and the value of each contribution (excluding that of the site) shall be ascertained by the parties to the venture through joint assessment.

Article 6 A joint venture shall have a board of directors with a composition stipulated in the contracts and the articles of association after consultation between the parties to the venture, and each director shall be appointed or removed by his own side. The board of directors shall have a chairman appointed by the Chinese participant and one or two vice-chairmen appointed by the foreign participant(s). In handling an important problem, the board of directors shall reach decision through consultation by the participants on the principle of equality and mutual benefit.

The board of directors, is empowered to discuss and take action on, pursuant to the provisions of the articles of association of the joint venture, all fundamental issues concerning the venture, namely, expansion projects, production and business programmes, the budget, distribution of profits, plans concerning manpower and pay scales, the termination of business, the appointment or hiring of the president, the vice-president(s), the chief engineer, the treasurer and the auditors as well as their functions and powers and their remuneration, etc.

The president and vice-president(s) (or the general manager and assistant general manager(s) in a factory) shall be chosen from the various parties to the joint venture.

Procedures covering the employment and discharge of the workers and staff members of a joint venture shall be stipulated according to law in the agreement

or contract concluded between the parties to the venture.

Article 7 The net profit of a joint venture shall be distributed between the parties to the venture in proportion to their respective shares in the registered capital after the payment of a joint venture income tax on its gross profit pursuant to the tax laws of the People's Republic of China and after the deductions therefrom as stipulated in the articles of association of the venture for the reserve funds, the bonus and welfare funds for the workers and staff members and the expansion funds of the venture.

A joint venture equipped with up-to-date technology by world standards may apply for a reduction of or exemption from income tax for the first two to three profit-making years.

A foreign participant who re-invests any part of his share of the net profit within Chinese territory may apply for the restitution of a part of the income taxes paid.

Article 8 A joint venture shall open an account with the Bank of China or a bank approved by the Bank of China.

A joint venture shall conduct its foreign exchange transactions in accordance with the Foreign Exchange Regulations of the People's Republic of China.

A joint venture may, in its business operations, obtain funds from foreign banks directly.

The insurances appropriate to a joint venture shall be furnished by Chinese insurance companies.

Article 9 The production and business programmes of a joint venture shall be filed with the authorities concerned and shall be implemented through business contracts.

In its purchase of required raw and semi-processed materials, fuels, auxiliary equipment, etc., a joint venture should give first priority to Chinese sources, but may also acquire them directly from the world market with its own foreign exchange funds.

A joint venture is encouraged to market its products outside China. It may distribute its export products on foreign markets through direct channels or its associated agencies or China's foreign trade establishments. Its products may also be distributed on the Chinese market.

Wherever necessary, a joint venture may set up affiliated agencies outside China.

Article 10 The net profit which a foreign participant receives as his share after executing his obligations under the pertinent laws and agreements and contracts, the funds he receives at the time when the joint venture terminates or winds up its operations, and his other funds may be remitted abroad through the Bank of China in accordance with the foreign exchange regulations and in the currency or currencies specified in the contracts concerning the joint venture.

A foreign participant shall receive encouragements for depositing in the Bank of China any part of foreign exchange which he is entitled to remit abroad.

Article 11 The wages, salaries or other legitimate income earned by a foreign worker or staff member of a joint venture, after payment of the personal income tax under the tax laws of the People's Republic of China, may be remitted abroad through the Bank of China in accordance with the foreign exchange regulations.

Article 12 The contract period of a joint venture may be agreed upon between the parties to the venture according to its particular line of business and circumstances. The period may be extended upon expiration through agreement between the parties, subject to authorization by the Foreign Investment Commission of the People's Republic of China. Any application for such extension shall be made six months before the expiration of the contract.

Article 13 In cases of heavy losses, the failure of any party to a joint venture to execute its obligations under the contracts or the articles of association of the venture, force majeure, etc., prior to the expiration of the contract period of a joint venture, the contract may be terminated before the date of expiration by consultation and agreement between the parties and through authorization by the Foreign Investment Commission of the People's Republic of China and registration with the General Administration for Industry and Commerce. In cases of losses caused by breach of the contract(s) by a party to the venture, the financial responsibility shall be borne by the said party.

Article 14 Disputes arising between the parties to a joint venture which the board of directors fails to settle through consultation may be settled through conciliation or arbitration by an arbitral body of China or through arbitration by an arbitral body agreed upon by the parties.

Article 15 The present law comes into force on the date of promulgation. The power of amendment is vested in the National People's Congress.

As published in the ACFERT Editorial Board (1984), pp 428-9.

APPENDIX D

Regulations on Economic Association Between the Xiamen Special Economic Zone and Inland Areas of China

Approved at the Eighth Session of the Standing Committee of the Sixth Fujian Provincial People's Congress on July 14, 1984

Promulgated by the Standing Committee of Fujian Provincial People's Congress on February 24, 1985

Article 1 The present regulations are formulated in line with the relevant laws and decrees of the People's Republic of China, with a view to strengthening the economic and technical cooperation between the special zone and inland areas of China and promoting the growth of the national economy.

Article 2 Enterprises of various provinces, municipalities directly under the State Council and autonomous regions and central government departments may, on the principle of equality and mutual benefit, make investment in the special zone to run industrial, commercial, communications and transport undertakings, public utilities,

building trade, restaurants, and undertakings in science, technology, culture, education and other enterprises. The above-mentioned enterprises and undertakings are encouraged to invest in Xiamen City in the area of upgrading the technology of the city's existing enterprises.

Article 3 Forms of the economic association between the special zone and the inland areas (hereinafter refered to as innerly associated enterprise) are:

(1) tripartite association among those from the inland areas and the SEZ and foreign firms;

(2) association between the inland areas and the special zone; and

(3) enterprises wholly-owned by inland areas and other forms of participation.

The first two forms of association, (1) and (2), may take the form of equity joint venture or contractual cooperation.

Article 4 An inland enterprise or undertaking which invests in the SEZ must produce the certificate proving its legal person status and the certificate issued by the relevant county department or department(s) above the county level, when they negotiate with the relevant units of the SEZ. Once a contract is signed it must be examined and approved by the Xiamen City People's Government, and go through the procedures of registration with the Xiamen City Administration for Industry and Commerce.

Article 5 Innerly associated enterprises and undertakings established in the SEZ should be subordinated to the overall planning and unified management of the SEZ, abide by the zone's laws and decrees and their legitimate rights and interests are protected by law.

Article 6 The income tax rate is 15% for those innerly associated enterprises and undertakings with the composition of foreign capital; while those without the composition of foreign capital but are engaged in undertakings of a developmental nature will enjoy tax deduction or exemption for one to three years starting from the first profit-making year with the approval of the Xiamen Tax Bureau.

Article 7 Products of the innerly associated enterprises are mainly for export.

Article 8 An innerly associated enterprise should open an account with a SEZ-based bank. That part of the net profit allocated to the inland party may be freely remitted to the inland areas; it may also be used to purchase equipment and materials in the SEZ or the international market, and transported to the inland area after paying the customs duties according to the customs regulations.

Article 9 An appropriately higher percentage may be offered in the foreign exchange part of the profit sharing for the inland party in innerly associated enterprises, if no composition of foreign capital is involved. The specific ways of doing this may be discussed and determined by the two parties concerned.

Article 10 The number of personnel of the inland party of an innerly associated enterprises who are dispatched to the special zone is to be checked and determined by the Xiamen City People's Government. These personnel should apply for temporary residence permits.

Article 11 The non-rotating management executives and technicians sent by the inland party to these innerly associated enterprises may apply for permanent residence in the SEZ and appropriate consideration may also be given to their family members to accompany them, if the term of cooperation between the two parties is more than five years and the economic results are good after the first year's business operation.

Article 12 When the term of cooperation expires or is terminated half-way, assets may be sold freely, funds may be remitted back and the party that sends the employees to the special zone is to be responsible for their reemployment after the innerly associated enterprise has gone through the cancellation procedures as regards its business registration.

Article 13 The present regulations shall come into force on the date of promulgation.

As published in the ACFERT Editorial Board (1986), pp 646-7.

APPENDIX E

Provisions for the Improvement of Foreign Investment Environment in Xiamen Special Economic Zone

November 10, 1986

I. Improving management, simplifying procedures and raising work efficiency.

A decision has been made to set up a Xiamen municipal heading group in charge of foreign investment in order to strengthen the leadership over and the coordinating work of foreign investment, and to arbitrate and handle relevant important problems.

All departments of the Municipal Government shall further improve its work efficiency. Xiamen Municipal Foreign Economic Relations and Trade Commission shall give a formal reply to any foreign investor applying for setting up an enterprise with foreign investment within one month from the date of receipt of the whole set of documents. The Customs shall complete at one time the procedures concerning the application for registration of enterprise, contract examination and approval, issuance of import material entry pamphlets and examination and approval of tax reduction and exemption in its declaration hall in a coordinated process. The Administrative Bureau of Industry and Commerce shall give a reply to the application for registration or for changes in registration within seven days from the date of receiving the application and related documents. The Department of Commodity Inspection shall issue the certificate within twenty days after receiving an application for inspection, so as to avoid delay in fixing claims on imports, in making shipment and settlement in trade. The Taxation Department shall give a reply to the application for tax reduction or exemption as well as to the taxation appeal within fifteen days from the date of receipt of the application.

II. Providing good service to enterprises with foreign investment.

1. To set up a service company for enterprises with foreign investment, provide investors with information consultancy service, assist in handling the application procedures and give other services;

2. To set up an engineering and technological consultancy company to assist investors in engineering and technological consultancy, project evaluation, and feasibility study upon entrustment;

3. To set up a material supply company for enterprises with foreign investment to help them solve the problem of material supply required in production and construction.

III. Productive enterprises with foreign investment may enjoy the following preferential treatments provided the related contract includes the plan of product marketing abroad and of import and export:

Application, approval and import licence may be dispensed with where import of machinery and equipment, vehicles for use in production, raw materials, fuel, bulk parts, spare parts, components and fittings (including imports restricted by the State) is needed. The Customs department will exercise supervision and the examination and release the import or export on the strength of the contract of the enterprises or the import and export contract.

According to Document No. 85 issued by the State Council in 1985, certain policies concerning free port will be gradually implemented in Xiamen Special Economic Zone. At present, the emphasis is to be laid on the development of bonded factories, bonded warehouses and boned zones as well as on transit and re-export trades. Any enterprise which is qualified for having a bonded warehouse

or a bonded factory (i.e. having a special factory, warehouse, special persons in charge and a special account) and observing the regulations of the Customs may apply to the Customs for examination and approval. The Customs will appoint its officials to station at the factory or warehouse to supervise and check import and export commodities on the spot.

IV. Credit funding and foreign exchange adjusting.

Export enterprises and technologically advanced enterprises, after examination by the Bank of China, Xiamen branch, other specialized banks and Xiamen International Trust and Investment Company, will be given priority in obtaining short term revolving funds and the necessary credit funds. Banking business such as current account overdraft, foreign exchange mortgage, fixed asset mortgage, and export documentary credits are to be developed to solve the problem of circulating funds in RMB or in foreign exchange as may be encountered by enterprises with foreign investment. Under the supervision of the foreign exchange control department, enterprises with foreign investment may mutually adjust their foreign exchange surpluses and deficiencies.

V. Continuing the checking-up and readjustment of fee-collection items and scales, and reducing the charge to enterprises with foreign investment.

The Municipal Government has decided to cancel six items of fee-collection, such as gas development fee, examination and approval fee for import and export, etc. Enterprises with foreign investment will be charged the same as state-run enterprises for such items as medical care, initial telephone installation, commission for international direct distance dialing, road maintenance for city buses, supplies of water, power and gas, cargo transportation, engineering design, consultancy service, advertisment, etc. If enterprises with foreign investment are charged unreasonably, they may refuse to pay and may also appeal to the Municipal Foreign Economic Relations and Trade Commission or other higher authorities.

VI. Providing special preferential treatment to productive enterprises investing in Huli Industrial District.

The site use fee for enterprises with foreign investment will be charged at RMB 5 yuan per square metre per year. If it is lower than RMB 5 yuan in the contracts already signed, the original one remains effective. The price and rent for general-purpose factories will be cut down by 10%. General-purpose factories may be purchased by installment payment, 30% of the selling price paid in the first installment and th rest paid within one year. Subsidies for electricity and the charge for capacity-increase of water pipe for enterprises with foreign investment will also be cancelled. A bonded zone will be established in Huli Industrial District. Under the supervision of the Customs, foreign stored, processed, repacked and relabeled in the bonded zone and re-exported.

VII. Permitting the transfer of personnel.

Enterprises with foreign investment may, in accordance with their production and operation requirement, determined by themselves the employment or dismissal of their staff members and workers. Technical and managerial personnel may be employed locally or from other parts of China or from abroad. The unit to which such employees belong should support and permit their resignation and employment. Their working years before resignation and after employment may be calculated successively. After the expiration of the labour contract, the personnel and labour departments should assist them in finding jobs.

VIII. Prices for the products manufactured by enterprises with foreign investment and approved for domestic sale may be fixed by the enterprises themselves according to the supply and demand of the market except the unified prices fixed by the State for certain commodities.

These Provisions shall go into effect on the date of promulgation.

As published in the ACFERT Editorial Board (1987), pp 201-2.

APPENDIX F

The Regression Analysis of the Price Index and Growth of Foreign Trade in the Xiamen SEZ (1970 - 1989)[16]

1). Calculation of least squares coefficients:

i	Y_i(PI)	X_i(T/Y)	$y_i=Y_i-\overline{Y}$	$x_i=X_i-\overline{X}$	y_ix_i	x_i^2	y_i^2	X_i^2
1	98.4	0.0913	-7.7	-0.0892	0.6868	0.0080	59.29	0.0083
2	100.0	0.1027	-6.1	-0.0778	0.4746	0.0061	37.21	0.0105
3	100.7	0.0998	-5.4	-0.0807	0.4358	0.0065	29.16	0.0100
4	100.1	0.1006	-6.0	-0.0799	0.4794	0.0064	36.00	0.0101
5	99.8	0.0946	-6.3	-0.0859	0.5412	0.0074	39.69	0.0089
6	100.1	0.1073	-6.0	-0.0732	0.4392	0.0054	36.00	0.0115
7	100.2	0.1141	-5.9	-0.0664	0.3918	0.0044	34.81	0.0130
8	100.1	0.0996	-6.0	-0.0809	0.4854	0.0065	36.00	0.0099
9	100.3	0.1207	-5.8	-0.0598	0.3468	0.0036	33.64	0.0146
10	102.9	0.1507	-3.2	-0.0298	0.0954	0.0009	10.24	0.0227
11	103.2	0.1742	-2.9	-0.0063	0.0183	0.0000	8.41	0.0303
12	104.7	0.1847	-1.4	0.0042	-0.0059	0.0000	1.96	0.0341
13	102.6	0.1791	-3.5	-0.0014	0.0049	0.0000	12.25	0.0321
14	101.9	0.1812	-4.2	0.0007	-0.0029	0.0000	17.64	0.0328
15	107.2	0.2481	1.1	0.0676	0.0744	0.0046	1.21	0.0616
16	123.1	0.3076	17.0	0.1271	2.1607	0.0162	289.00	0.0946
17	109.8	0.2105	3.7	0.0300	0.1110	0.0009	13.69	0.0443
18	111.9	0.3058	5.8	0.1253	0.7267	0.0157	33.64	0.0935
19	130.1	0.3803	24.0	0.1998	4.7952	0.0400	576.00	0.1446
20	124.8	0.3567	18.7	0.1762	3.2949	0.0310	349.69	0.1272
Σ	2121.9	3.6096	-0.1*	-0.0004*	15.5536	0.1634	1655.53	0.8149
	$\overline{Y}$ = 106.095		$\overline{X}$ = 0.18048					

* should be zero, but slight rounding error is due to approximation of means.

Thus,

$$\overline{X} = \frac{\Sigma X_i}{n} = \frac{3.6096}{20} = 0.18048; \quad \overline{Y} = \frac{\Sigma Y_i}{n} = \frac{2121.9}{20} = 106.095$$

And so $$b = \frac{\Sigma y_i x_i}{\Sigma x_i^2} = \frac{15.5536}{0.1634} = 95.19$$ and

$$a = \overline{Y} - b\overline{X} = 106.095 - (95.19)(0.18048) = 88.92.$$

The fitted relationship is therefore:

$$\hat{Y}_i = a + bX_i = 88.92 + 95.19X_i$$

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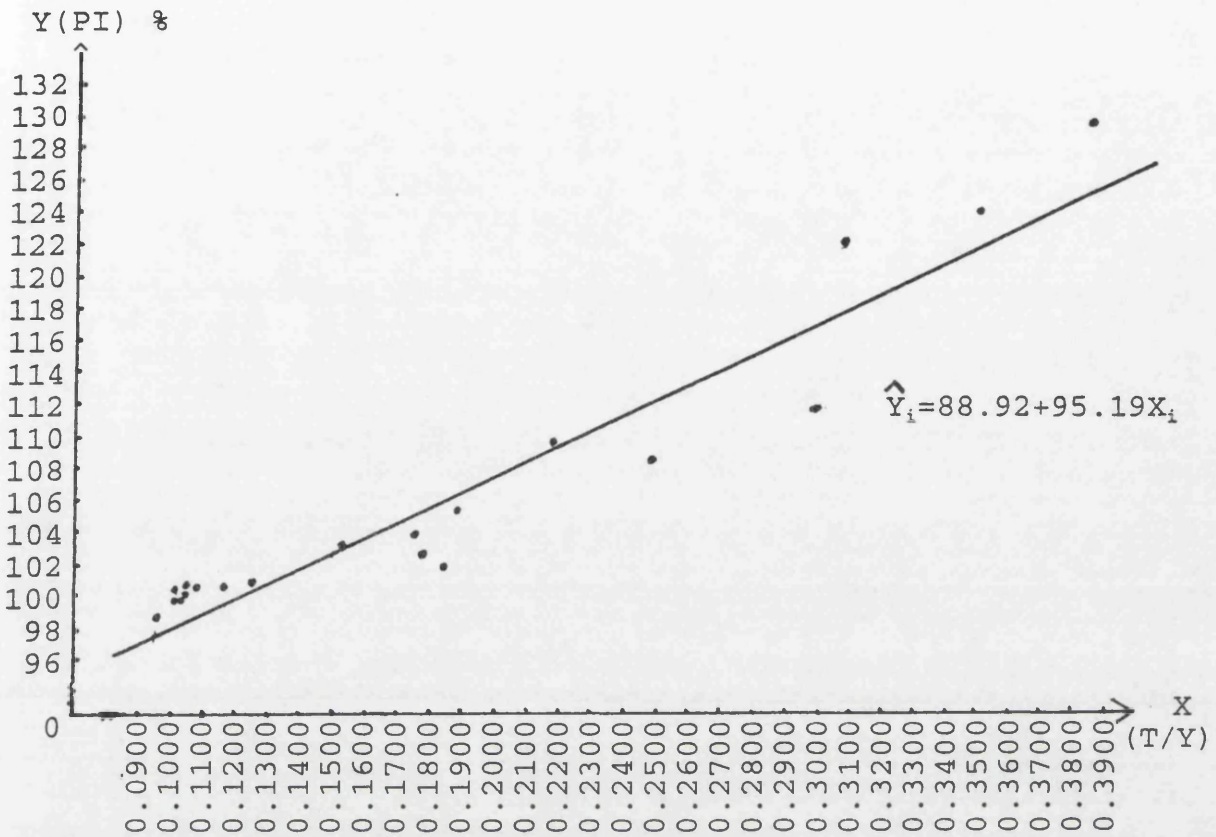
16. For explanation of the statistical method, refer to John D. Hey (1974).

which is graphed in the following figure:



2). Calculation of estimated deviations:

i	Y_i(PI)	X_i(T/Y)	$\hat{Y}_i$	$e_i=Y_i-\hat{Y}_i$	e_{i-1}	e_i^2	e_i-e_{i-1}	$(e_i-e_{i-1})^2$
1	98.4	0.0913	97.61	0.79	----	0.6241	----	------
2	100.0	0.1027	98.70	1.30	0.79	1.6900	0.51	0.2601
3	100.7	0.0998	98.42	2.28	1.30	5.1984	0.98	0.9604
4	100.1	0.1006	98.50	1.60	2.28	2.5600	-0.68	0.4624
5	99.8	0.0946	97.92	1.88	1.60	3.5344	0.28	0.0784
6	100.1	0.1073	99.13	0.97	1.88	0.9409	-0.91	0.8281
7	100.2	0.1141	99.78	0.42	0.97	0.1764	-0.55	0.3025
8	100.1	0.0996	98.40	1.70	0.42	2.8900	1.28	1.6384
9	100.3	0.1207	100.41	-0.11	1.70	0.0121	-1,81	3.2761
10	102.9	0.1507	103.27	-0.37	-0.11	0.1369	-0.26	0.0676
11	103.2	0.1742	105.50	-2.30	-0.37	5.2900	-1.93	3.7249
12	104.7	0.1847	106.50	-1.80	-2.30	3.2400	0.50	0.2500
13	102.6	0.1791	105.97	-3.37	-1.80	11.3569	-1.57	2.4649
14	101.9	0.1812	106.17	-4.27	-3.37	18.2329	-0.90	0.8100
15	107.2	0.2481	112.54	-5.34	-4.27	28.5156	-1.07	1.1449
16	123.1	0.3076	118.20	4.90	-5.34	24.0100	10.24	104.8576
17	109.8	0.2105	108.96	0.84	4.90	0.7056	-4.06	16.4836
18	111.9	0.3058	118.03	-6.13	0.84	37.5769	-6.97	48.5809
19	130.1	0.3803	125.12	4.98	-6.13	24.8004	11.11	123.4321
20	124.8	0.3567	122.87	1.93	4.98	3.7249	-3.05	9.3025
Σ	2121.9	3.6096	2121.99[a]-0.10[b]	---	175.2164	-----	318.9254	

a. should equal ΣY_i, but slight inaccuracy is due to rounding error;
b. should be zero, but slight inaccuracy is due to rounding error.

b. should be zero, but slight inaccuracy is due to rounding error.

Thus

$$R^2 = 1 - \frac{\Sigma e_i^2}{\Sigma y_i^2} = 1 - \frac{175.2164}{1655.53} = 0.894 \quad \text{and}$$

$$s^2 = \frac{1}{n-2}\Sigma e_i^2 = \frac{1}{18}(175.2164) = 9.734; \quad s = 3.12$$

3). Testing regression coefficients:

H_0: $\alpha = 0$

H_1: $\alpha \neq 0$

$$t_a = \frac{a - \alpha\sqrt{n\Sigma x_i^2}}{s\sqrt{\Sigma X^2}} = \frac{88.92\sqrt{20(0.1634)}}{3.12\sqrt{0.8149}} = \frac{160.746}{2.816} = 57.073$$

When D.F.=18, $P(-3.922 > t_{18} > 3.992) = 0.0005$. So we reject the null hypothesis H_0: $\alpha = 0$ in favour of the alternative that H_1: $\alpha \neq 0$. This means that the coefficient *a* is significant with 99.95% confidence.

Similarly,

H_0: $ß = 0$

H_1: $ß \neq 0$

$$t_b = \frac{b - ß\sqrt{\Sigma x_i^2}}{s} = \frac{95.19\sqrt{0.1634}}{3.12} = \frac{38.478}{3.12} = 12.333$$

So we again reject H_0: $ß = 0$ and accept H_1: $ß \neq 0$. This means that the regression coefficient, *b*, is also significant with 99.95% confidence.

4). Calculation of Durbin-Watson Statistics:

$$D - W = \frac{\Sigma(e_i - e_{i-1})^2}{\Sigma e_i^2} = \frac{318.9254}{175.2164} = 1.82$$

When $n = 20$ and $k = 1$, $d_L = 1.20$ and $d_U = 1.41$ at the 5% significance level. So we accept (at 5% significance level) the null hypothesis of no auto-correlation.

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